Institute of Strategic and International Studies (ISIS) Malaysia

CURRENT ECONOMIC SITUATION
(SELECTED ARTICLES FROM MAGAZINES)

NOVEMBER 2009

INFORMATION SERVICES DIVISION
ISIS MALAYSIA

CONTENTS

CURRENT ECONOMIC SITUATION

18. The curse of defeatism. **The Economist**, November 28, 2009, pp. 12-14.

19. The gloves go on. **The Economist**, November 28, 2009, pp. 62.

20. Standing still but still standing. **The Economist**, November 28, 2009, pp. 75.

21. A load to bear. **The Economist**, November 28, 2009, pp. 76.

22. Same chords different tune. **The Economist**, November 28, 2009, pp. 77.

23. A developing bull market. **The Economist**, November 28, 2009, pp. 80.

24. Systems failure. **The Economist**, November 28, 2009, pp. 82.

25. China's house of cards? By Bill Powell. **Fortune**, November 23, 2009, pp. 28.

26. The shrinking of China by Duncan Hewitt. **Newsweek**, November 2, 2009, 2009, pp. 43-45.

27. Economic versus extremism by Vali Nasr. **Newsweek**, November 2, 2009, pp. 46-48.

28. The boom in the gloom by Rana Foroohar. **Newsweek**, November 9, 2009, pp. 24-27.

29. The modest superpower by Stefan Theil. **Newsweek**, November 16, 2009, pp. 31-33.

30. World laughs at Wall Street's ego by Rana Foroohar. **Newsweek**, November 16, 2009, pp. 8.

31. Watching the yuan by Rana Foroohar. **Newsweek**, November 22, 2009, pp. 8.

32. Controlling the currencies by Rana Foroohar. **Newsweek**, November 30, 2009, pp. 11.

33. A better measure by Stephan Faris. **Time**, November 12, 2009, pp. 52.

34. Tower of power by Austin Ramzy. **Time**, November 2, 2009, pp. 41-43.

35. 5 things the U.S. can learn from China by Bill Powell. **Time**, November 23, 2009, pp. 25-31.

36. Can an eagle hug a panda? By Zachary Karabell. **Time**, November 30, 2009, pp. 28-29.

37. Rebalancing act by Michael Schuman. **Time,** November 30, 2009, pp. 37-39.

WORLD

United in Diversity

East Asian nations promote economic growth through regional cooperation to battle the world recession

By DING YING

From October 23 to 25, Chinese Premier Wen Jiabao attended the 12th China-ASEAN (Association of Southeast Asian Nations) summit, the 12th ASEAN Plus Three summit and the fourth East Asia summit in Hua Hin, Thailand.

In conclusion, Foreign Minister Yang Jiechi noted that the Chinese Premier was instrumental in helping ensure the success of the ASEAN summits.

During these meetings, Wen offered suggestions on fighting the financial crisis by enhancing regional cooperation. The premier's ideas addressed both the immediate and urgent issues of common concern while taking into account long-term strategic planning, Yang said.

"These proposals fully indicated China's goodwill, sincerity, and its confidence and willingness for cooperation," he said.

The foreign minister specified China's achievements during the visit in the following three aspects:

First, actual cooperation between China and its ASEAN partners has deepened. Since 1991, Beijing and ASEAN set up close trade, economic and political relations, complemented by mutual trust and cultural exchanges. Both sides have since confirmed a number of key cooperative fields, including agriculture and telecommunications, and conducted practical cooperation in nearly 30 fields. And completion of the China-ASEAN free trade area (FTA) is expected by 2010.

At the China-ASEAN summit, the Chinese Premier vowed to boost bilateral cooperation in several fields: making the most of the China-ASEAN FTA to advance bilateral relations on all fronts; increasing Chinese investment in ASEAN members; protecting intellectual property rights; and eliminating trade barriers.

Other proposals include accelerating infrastructure construction; deepening agricultural cooperation; and helping ASEAN members increase food productivity. Beijing also plans to assist ASEAN in environmental protection and the use of clean energy. In this regard, China plans to train 100 government officials on environmental protection strategies for ASEAN over the next three years.

In terms of promoting regional health, China hopes to work together with ASEAN on A/H1N1 flu preventioh. Cooperation will also be extended to the areas of defense, culture, education, tourism and cracking down on cross-border crime.

In April, Wen declared the Chinese Government would establish a $10 billion China-ASEAN Fund on Investment Cooperation to support infrastructure development in the region. Beijing, he added, also planned to offer $15 billion in loans to ASEAN countries and 270 million yuan ($39.5 million) in special aid to less developed ASEAN economies. In Hua Hin, Wen said the China-ASEAN fund would become available by the end of this year.

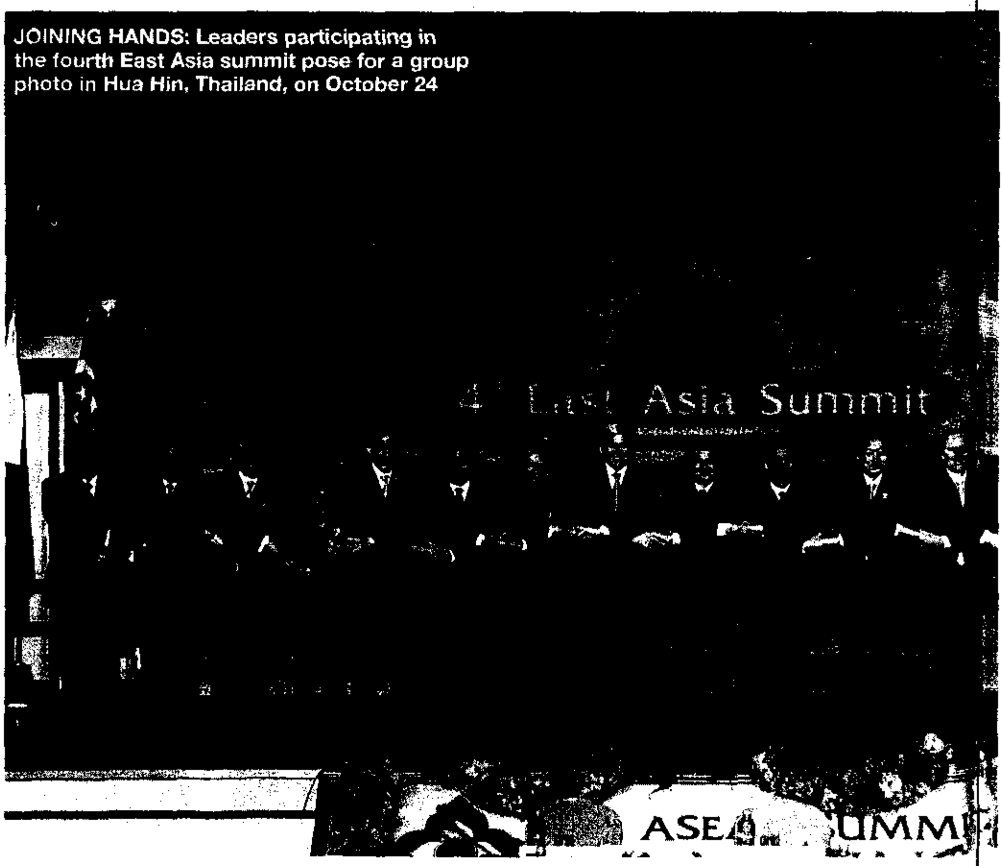
Meanwhile, China voiced support for full ASEAN integration and its leading role in regional cooperation.

Second, China has contributed to deepening regional cooperation among East Asian nations. "China is among the first countries to support cooperation among East Asian nations," said Yang.

Wen noted the large populations, diverse cultures and varied levels of development shared by East Asian nations, in addition to diverse cooperation mechanisms.

Nonetheless, he urged countries in East Asia to safeguard common ground via sustainable ties that can preserve ongoing regional economic and social development.

Wen noted during the ASEAN Plus Three summit that the ASEAN Plus Three



JOINING HANDS: Leaders participating in the fourth East Asia summit pose for a group photo in Hua Hin, Thailand, on October 24 cooperation should consider the global financial crisis as its most urgent task.

He further proposed that the road to economic recovery among East Asian nations lies in structuring financial and monetary policies with which to stimulate economic growth and overall stability.

Countries in the region, added Wen, should further deepen financial ties by constructing regional foreign exchange reserves and institutions that may implement regional economic surveillance.

Wen further hinted he hoped the Chiang Mai Initiative Multilateralization, a $120 billion regional reserve pool aimed at providing emergency liquidity for countries in financial crisis, could be launched by the end of this year. China, he added, is willing to offer $200 million to the region's credit guarantee and investment fund.

Wen said East Asia cooperation should focus on enlarging trade and investment within the region by pushing forward trade facilitation and building efficient regional infrastructure networks. The development of an East Asia free trade area, moreover, should be promoted and China is willing to head ASEAN Plus Three trade and economic cooperation, he added.

The Chinese Premier also urged East Asian countries to enhance cooperation in the green economy, modern agriculture and the manufacturing industry.

Third, the summits helped improve bilateral relations between China and neighboring countries.

While meeting with his Indian counterpart Manmohan Singh, for example, the two leaders agreed to push forward the two countries' strategic cooperative partnership.

They agreed to adhere to neighborly relations, maintain high-level interactions and enhance mutual political trust while expanding cooperation of mutual benefit. They also pledged to jointly address issues such as the global financial crisis and climate change.

When meeting with Australian Prime Minister Kevin Rudd, Wen said the two countries should handle their bilateral ties on the principles of "mutual respect, equality and mutual benefit, and seeking common ground while reserving differences."

The two countries, he added, should respect and care for each other's core interests and major concerns. The two leaders also agreed to speed up negotiations on a free trade agreement between China and Australia. ■

PANG XINGLEI

FTA on Track

The cooperation between China and ASEAN on how to perfect the China-ASEAN FTA became one of the most important agenda items during Chinese Premier Wen Jiabao's Thailand trip from October 23 to 25.

China and ASEAN started their dialogues in 1991 and, five years later, China became ASEAN's full dialogue partner. During the sixth China-ASEAN summit, meanwhile, the two sides went on to sign an all-around economic cooperation framework agreement. In it, they decided to build a China-ASEAN FTA by 2010.

More recently, China and ASEAN finished their negotiations on the FTA in August this year, vowing to formally launch the FTA as scheduled on January 1, 2010. At that point, the China-ASEAN FTA will become Asia's largest and the world's third largest FTA with a trade volume of $4.5 trillion and a combined gross domestic product of $6 trillion, following the North American FTA and the European FTA. But in terms of the 1.9-billion population it covers, it will be the largest FTA in the world.

ASEAN Secretary General Surin Pitsuwan told the Xinhua News Agency that the FTA would benefit both sides. Goods, services and investment, for one thing, can flow more freely within the FTA, which would contribute to the economic health of the entire region.

He noted that establishing the FTA is the natural outcome of the fast-growing trade and economic relationship between China and ASEAN. In 2002, bilateral trade volume was only $54.7 billion, but by 2008, the trade volume skyrocketed to $231.1 billion.

China is now ASEAN's third biggest trading partner. ASEAN states, indeed, have reaped massive profits from China's economic growth, according to the secretary general, who added that Beijing's industrial and manufacturing sectors would also benefit from the incoming free trade.

China and ASEAN countries started to cut tariffs in July 2005. By 2010, China and six ASEAN members, Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand, are expected to withdraw tariffs on all commodities. The remaining four ASEAN members, Viet Nam, Cambodia, Laos and Myanmar, on the other hand, will experience a transitional period of five more years. They will participate in full free trade with China in 2015.

Observers have pointed out there are several problems that need to be addressed before the FTA opens, such as China's trade surplus with ASEAN members. Once the FTA starts, ASEAN may worry that China's trade surplus will increase, leading to a run on Chinese products, which, in turn, could impact their small and medium-sized enterprises. This could lead to further unemployment inside the organization.

Because trade serves as the basis of economic integration, the bilateral trade range should be developed to wider categories, so as to promote trade within the FTA. Although in recent years Chinese investment to ASEAN members has grown steadily, investment volume remains still much lower than that of ASEAN members to China.

Moreover, China-ASEAN cooperation should be improved with the regionalization of the Chinese currency. Cross-border renminbi settlement would generate a great push toward trade facilitation and economic integration.

Neighbors in Trade

China's Guangxi Zhuang Autonomous Region has achieved rapid growth in its trade with the neighboring Viet Nam

By WANG JUN

Lai Kim is chairman of Binh Tan Consumer Goods Manufacturing Ltd. in Viet Nam's Ho Chi Minh City. Producing rubber slippers, as well as polyurethane and foam shoes, his company began exporting products to China over a decade ago. Via its agent in Guangxi Zhuang Autonomous Region in south China, Binh Tan can sell its products to other parts of China.

Every year, the company exports about 20 percent of its products to China at a value of at least $1 million. Its exports to China have grown fast within the last six years. They surged 30 percent in 2008 alone. "Our products are more and more popular in China," Lai Kim told *Beijing Review*.

Viet Nam has been the biggest trading partner of Guangxi. According to figures released by the Department of Commerce of Guangxi Zhuang Autonomous Region, in 2008, the foreign trade volume of Guangxi was $13.28 billion, with $7.35 billion of exports and $5.93 billion of imports.

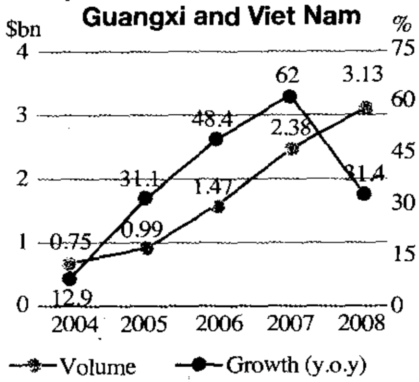
Of this total, its trade volume with Viet Nam was $3.13 billion, including $2.27 billion worth of exports to Viet Nam and $857 million of imports from Viet Nam.

Complementary partners

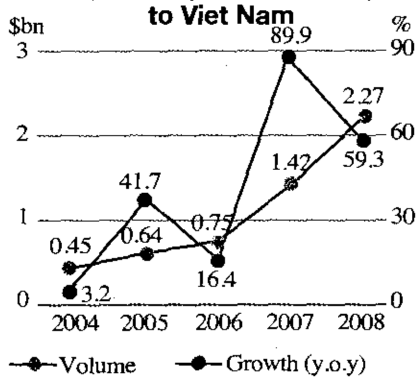
Guangxi and Viet Nam complement each other in terms of exporting and importing commodity structures. Major products that Guangxi exports to Viet Nam include walking tractors, fertilizers, grain seeds and building materials, among other things, according to Nong Lifu, Executive Deputy Director of the Institute of Southeast Asia at the Guangxi Academy of Social Sciences. Viet Nam's major exports to Guangxi, in turn, include coal, ore, minerals, tropical fruits and other types of produce.

Viet Nam and Guangxi may also be complementary to each other even in the same category of products. "Since the temperature in Viet Nam is higher than in Guangxi, fruits produced there ripe earlier than in Guangxi, but are also off-season earlier," Nong said. "Thus, Viet Nam also needs to import fruits from Guangxi when their fruits are out of season."

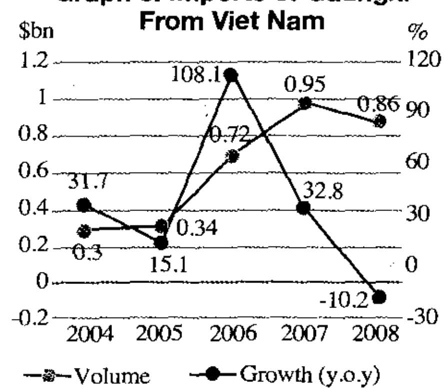
Graph 1: Trade Volume Between Guangxi and Viet Nam



Graph 2: Exports of Guangxi to Viet Nam



Graph 3: Imports of Guangxi From Viet Nam



(Source: *Bureau of Statistics of Guangxi Zhuang Autonomous Region*)

At the Roundtable Dialogue of the sixth China-ASEAN Business and Investment Summit held on October 20 in Guangxi's capital city of Nanning, Vietnamese Standing Deputy Prime Minister Nguyen Sinh Hung said trade between Viet Nam and Guangxi can help improve living standards on both sides of the border.

According to Nguyen, the market of Viet Nam and Guangxi covers a population of nearly 200 million, with enormous potential.

Unparalleled advantages

The land border between Guangxi and Viet Nam is 1,020 km long, with eight counties or cities in Guangxi directly bordering Viet Nam.

In Guangxi, there are 12 ports open to foreign trade and 25 trading areas for border inhabitants. Because of favorable geographic advantages, Guangxi and Viet Nam have long had trading relations with each other.

In 2008, according to Nong, Guangxi's trade with Viet Nam accounted for some 80 percent of the total trade volume between Guangxi and the Association of Southeast Asian Nations (ASEAN).

In terms of geographic proximity, some ethnic groups in Guangxi and Viet Nam share similar languages, customs and habits; therefore they can often understand each other. As a result, added Nong, this lessens the likelihood of fraud during their transactions.

In Guangxi, meanwhile, there are large numbers of students majoring in the Vietnamese language, and it is not difficult for these students to find jobs thanks to the autonomous region's abundant business opportunities with Viet Nam. All these factors have greatly facilitated cross-border trade, and have made Guangxi an important transition point for Vietnamese products to China.

Nong added further that about 70 percent of the products Guangxi imports from Viet Nam are, in turn, sold to other parts of China.

China readjusted its policies on border trade in November 2008. Since then, border inhabitants can import duty-exempted commodities of 8,000 yuan ($1,171) instead of 3,000 yuan ($439) every day. This change also benefited the trade between

Guangxi and Viet Nam.

Tradeoffs

However, Nong added that the trade between Guangxi and Viet Nam also faces problems. The exporting commodity structures of both sides are still monotonous. Moreover, 70 percent of the products Guangxi imports from Viet Nam are then sold to other parts of China, while 70 percent of the products it exports to Viet Nam are originally made in other parts of the country.

In its trade with Guangxi, on the other hand, Viet Nam faces big deficits. In 2008, Viet Nam sold $857 million worth of goods to Guangxi, but bought $2.27 billion worth of goods from the autonomous region, with trade deficits of $1.41 billion.

Nong thinks that with rapid economic development, the market demand of Viet Nam increases fast. Hence imports, especially those of heavy machines, are growing rapidly.

In 2004, China and Viet Nam agreed on the establishment of "two corridors, one circle" with the aim of pushing up economic development of Guangxi and Viet Nam. The "two economic corridors" refer to "Kunming-Lao Cai-Hanoi-Hai Phong" and "Nanning-Lang Son-Hanoi-Hai Phong" economic corridors and "one circle" refers to the Beibu Gulf economic circle.

The Beibu Gulf lies between the Leizhou Peninsula and Hainan Province in south China and Viet Nam, covering an area of nearly 130,000 square km.

However, Nong said that the implementation of "two corridors, one circle" remains slow. "If established, 'two corridors, one circle' would further boost the trade between Guangxi and Viet Nam," Nong said. "It will also benefit the friendship between the two countries."

Freer trade

The China-ASEAN Free Trade Area (FTA) will be established on January 1, 2010. As a major free trade area in the world that covers a population of 1.9 billion, or 30 percent of the world's people, the FTA will conduct a zero-tariff policy on 90 percent of products traded between China and ASEAN. (See p.11)

"Establishment of the China-ASEAN FTA will promote the overall trade between China and ASEAN, especially in fields such as investment, service trade, educational cooperation and project contracting," Nong said.

To Vietnamese companies selling products to Guangxi, the direct benefit from the establishment of the China-ASEAN FTA is that they can expand their market shares, just as Viet Nam's Standing Deputy Prime Minister Nguyen said at the Roundtable Dialogue.

Take Lai Kim's company as an example. Their agent in Guangxi now has to pay tariffs of 20 percent to 30 percent. After the free trade area is established, tariffs will be reduced to zero. Lai Kim estimates their exports to Guangxi may increase by as much as 100 percent.

"By saving expenses in tariffs, our agent can put more funds in advertising and marketing to bring more products to China," Lai Kim said. ■

CROSS-BORDER TRADE: Border trade between Guangxi Zhuang Autonomous Region in south China and Viet Nam has become brisk in recent years. In this photo, Vietnamese who live near the bo... await entry into China via the C...

XINHUA

Intensifying Frictions

U.S. trade disputes against China abound, but few expect a full trade war between the two economic giants

By LAN XINZHEN

As the biggest developed and developing country, respectively, the United States and China, used to be complementary of and dependent on one another in terms of their import-export relationship. Now, the two have fallen upon unfortunate times as trade frictions increase in prevalence, becoming a contentious topic of discussion.

Tensions started on September 11, 2009, when U.S. President Barack Obama decided to levy three-year punitive tariffs on all car and light truck tires imported from China. Before Obama's visit to China on November 15, the United States had launched many trade protection actions against China, with tires, oil country tubular goods, coated paper, potassium pyrophosphate, monopotassium phosphate and potassium hydrogen phosphate becoming the targets of the United States' trade strike.

The frequency of anti-dumping and countervailing cases launched by the United States has been relatively high in the history of world trade.

In the interest of its domestic industries, China has implemented appropriate trade countermeasures, launching anti-dumping and countervailing investigations on certain automobiles and chicken products originating from the United States.

While these disputes account for a small proportion in the overall cooperation between China and the United States, the sudden frictions have already begun to affect the involved Chinese industries and companies.

At a seminar on international trade development held on November 7 in Tianjin, Yao Jian, spokesman for the Ministry of Commerce (MOFCOM), said that trade frictions between China and the United States are increasing and trade protectionist measures adopted by countries including the United States have already deeply affected China.

Why now?

The intensified trade protectionism measures adopted by the United States against China arose from the "framework for strong, sustainable and balanced growth" put forward by Obama at the G20 Summit held in Pittsburgh. The U.S. Government has proposed the idea that the financial crisis is a consequence of the imbalance in the global economy, especially the imbalance in trade between China and the United States. The trade protectionism measures against China are to balance the trade equation between the two countries, narrow the surplus and precipitate renminbi appreciation.

This viewpoint held by the U.S. Government, however, seems farfetched to many Chinese. At a seminar on trade, China and world economic order held in Beijing on October 23, Wu Xiaoling, Vice Chairman of the Finance and Economic Committee of the Standing Committee of the 11th National People's Congress, said trade surpluses or deficits are mainly caused by factors such as changes of the productivity layout and different labor costs. The global trend has seen countries that master new technologies—headed by the United States—transferring many of their manufacturing industries to emerging countries that have cheaper labor, while they themselves focus on developing service, financial and hi-tech industries. These changes in the productivity pattern and manufacturing industries decide the trade surplus and deficits, Wu said.

After realizing a free-floating exchange rate, Deutsche mark and Japanese yen both appreciated sharply against U.S. dollar, Wu said. By now, such appreciation hasn't completely eliminated the trade surplus by Germany and Japan against the United States.

Tu Xinquan, Deputy Director of the China Institute for WTO Studies of the University of International Business and Economics, thinks that the increase of trade frictions between China and the United States is actually closely related to the domestic economic situation in the United States, where a high unemployment rate and an industrial base in recession dominate the American economic landscape. In order to protect its domestic market and employment under such harsh economic conditions, the government is quick to yield to the country's trade protectionists.

Moreover, economic factors are not the only motive for the United States to launch trade protectionist measures. Domestic political pressure could also play an influential role in these kinds of trade actions. Strategic factors have also been known to play a more important role than economic factors in antimonopoly actions. The current economic crisis and domestic political struggles in the United States will only see a recurrence of American resistance to Chinese products, Tu said.

Mei Xinyu, a researcher at the Chinese Academy of International Trade and Economic Cooperation of the MOFCOM, thinks that China has found itself in the present trade situation because of previous ineffective counterblows.

On one hand, the Chinese Government seldom uses trade retaliation measures during trade disputes. When it does, many measures are not as serious as they could be, allowing foreign governments and companies to all but ignoring China's determination to take decisive actions to protect its interests.

CNSPHOTO

CHINESE REACTION: A customer in Beijing consults a salesperson about a BUICK car from the United States. China's Ministry of Commerce announced plans to launch an anti-dumping and countervailing investigation on certain U.S. automobile and chicken products in September

On the other hand, when facing trade remedy investigations by other countries, Chinese companies do not often have a firm understanding or ability to take effective measures to cope with the litigations. At times, Chinese firms will simply not respond to the charges, leaving the impression that they are weak and open to bullying, which only encourages trade protectionism to some extent, said Mei.

The case seems to be repeating itself now between China and the United States, as China is only hesitantly engaging in the trade dispute by launching token counterblows.

Is trade war possible?

A trade war between China and the United States would only make the two sides suffer financially and economically. China resolutely opposes trade protectionism, an act that will only seriously harm the international trade environment, greatly weaken the effect of economic stimulus measures adopted around the globe and obstruct the overall economic recovery, Yao said.

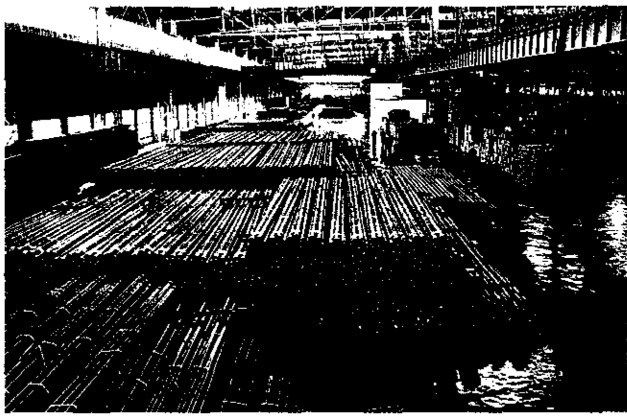
At a press conference held by the Ministry of Foreign Affairs on November 10, spokesman Qin Gang said that the Chinese side has called on the United States to engage in a joint effort with China to properly solve the frictions and problems concerning bilateral economic and trade relations.

According to Qin, the China-U.S. economic and trade relationship is one of the major pillars in China-U.S. ties. Unprecedented progress has been made in recent years, allowing the two countries to become important trade partners.

The frictions and disputes need to be appropriately addressed through communication and consultation based on equality and mutual respect. If improperly handled, the trade friction could escalate, triggering an all-out trade war, Qin said.

Liu Xiaozhong, a researcher at the China Business Network Institute based in Shanghai, in an Internet article stated that under the background of the global economic crisis there are obvious differences of interest between China and the United States. What the United States hopes China to bring to the table is exactly the thing that China cannot provide in the short term. Also, what China hopes the United States to maintain, such as moderate deficits and stable U.S. dollar exchange rate, is what the United States cannot currently control.

Although trade frictions are worsening, many economists interviewed by *Beijing Review* are optimistic about the trade trend between China and the United States. Both countries, they agree, are of sound economic minds, so it is unlikely that a trade war, which will benefit neither side, will occur. ■


SU XIAOZHOU

AMERICAN ACTION: Steel pipes produced by Hengyang Valin Steel Tube Co. Ltd. in Hunan Province are sold in more than 40 countries and regions of the world. The United States carried out anti-dumping and countervailing investigations on Chinese steel pipes and tires since October

China-U.S. Trade Frictions in the Past Two Months

U.S. Actions

On September 9, the U.S. Department of Commerce decided to levy a tariff on Chinese oil country tubular goods. The tariff ranges from 10.9 percent to 30.6 percent.

On September 11, U.S. President Obama decided to levy three-year punitive tariffs on all imported car and light truck tires from China. The tariff rate is set at 35 percent for the first year, 30 percent for the second year and 25 percent for the third year.

On October 28, the U.S. Department of Commerce announced its intention to impose a tariff of 7.44 percent to 12.06 percent on $269 million worth steel grafting and steel strands imported from China.

On October 30, the United States International Trade Commission voted 6-0 in favor of an anti-dumping and countervailing investigation on Chinese seamless steel pipes. The U.S. petitioners requested a 98.37-percent anti-dumping duty against certain seamless steel pipes imported from China.

On November 3, the U.S. Department of Commerce set preliminary duties ranging from 2.02 percent to 437.73 percent on imported steel wire decking from China to offset government subsidies.

On November 4, the United States requested that the WTO establish a dispute settlement panel to rule on the exports of raw materials by China.

On November 5, the U.S. Department of Commerce announced its intention to impose a 36.53-percent duty on oil country tubular goods from 37 Chinese companies and a preliminary anti-dumping rate of 99.14 percent on products of some other Chinese companies. This is the biggest trade action against China-made products adopted by the United States.

On November 6, the United States International Trade Commission announced its preliminary decision to levy anti-dumping and countervailing tariffs on coated paper imported from China and Indonesia, as well as potassium pyrophosphate, monopotassium phosphate, potassium hydrogen phosphate imported from China.

China's Response

On September 13, China's MOFCOM announced it would be launching an anti-dumping and countervailing investigation on certain auto products and chicken products originating from the United States in accordance with Chinese laws and WTO rules.

On October 12, the MOFCOM announced plans to impose five-year anti-dumping tariffs on some polyamide-66 chips imported from the United States, Italy, Britain and France starting on October 13. The tariff rate is up to 37.5 percent.

On October 20, the MOFCOM said that China would require a security deposit on nylon 6, or polycaprolactam, imported from the United States, the European Union, Russia and Taiwan.

On November 6, the MOFCOM announced plans to launch an anti-dumping and countervailing investigation on cars and sport utility vehicles of 2.0 liter and above imported from the United States.

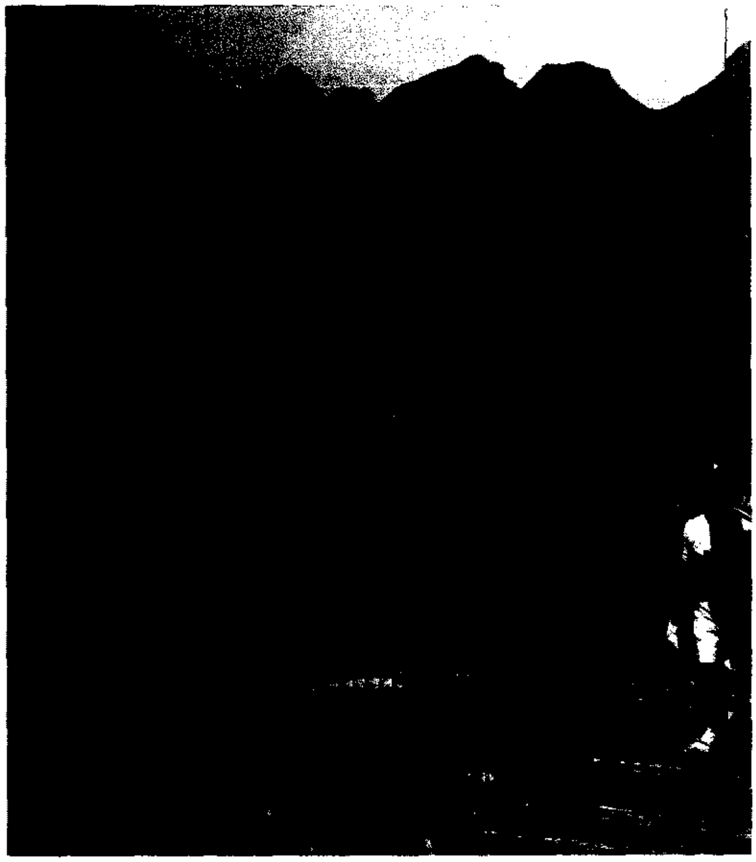
THE CHINA HYPE

By Dexter Roberts
and Pete Engardio
Illustration by Brian Stauffer

Despite an impressive rebound, an innovation shortfall may hobble sustainable growth

At the parade marking the 60th anniversary of the People's Republic of China, tanks and missiles trundled past the Forbidden City and down Beijing's Chang'an Avenue. Battalions of soldiers goose-stepped in perfect unison. Overhead, fighter jets soared in tight formation.

But close on the heels of this military extravaganza came floats highlighting a less bellicose side of China, what the leadership calls "indigenous innovation." On one, a 10-foot-high microscope, giant test tubes filled with blue liquid, and a white telescope signified China's scientific and technological achievements. Another featured a replica of a bullet train and a



RYAN PYLE/CORBIS

passenger jet to represent China's ambitions in transportation. A green-energy float was studded with windmills and oil rigs and flanked by hundreds of red-helmeted energy-industry workers, each carrying a solar panel.

From a rostrum perched above the giant portrait of Mao Zedong at the Gate of Heavenly Peace, President Hu Jintao watched over the proceedings. "The Chinese people have stood up," Hu declared, quoting Mao, who uttered those words at that very spot 60 years ago. The country, Hu added, is "full of confidence in the bright prospects of the great rejuvenation of the nation."

VINDICATION, FOR NOW

That sense of triumph permeates China these days. The mainland's quick rebound from the worldwide financial meltdown seems to have vindicated its brand of state-led capitalism. As the West struggles to recover, China is on track for 8% growth this year and is about to overtake Japan as the world's No. 2 economy and Germany as the No. 1 exporter. Now the mainland is charging ahead in new industries, unveiling homegrown airliners, electric cars, and high-speed trains.

But delve beneath the muscular statistics and hype about advances in strategic industries, and China doesn't seem so prepared to catapult into a role of global economic leadership. Experts familiar with highly touted Chinese achievements such as commercial jets and high-speed trains say the technologies that underpin them were largely developed elsewhere. There is no Chinese Sony, Toyota, or Samsung on the horizon. While Beijing's $586 billion stimulus package and a 150% increase in bank lending have spurred impressive growth, "the question," says Morgan Stanley Asia Chairman Stephen S. Roach, "is the quality of that growth."

By Beijing's own admission, the economic model that has powered China for three decades can no longer be counted on to move it forward. The mainland has prospered largely through construction and by exporting all manner of consumer goods churned out in low-wage factories; workers parked their savings in state-run banks, which then loaned the money to companies to make more stuff. But technology and managerial knowhow came mostly from multinationals, and the costs—pollution, decaying social services, and a yawning gap between the urban rich and rural poor—were largely ignored. Though that model has fueled phenomenal growth, Hu and others now call it "unbalanced" and "unsustainable."

So in recent years, Beijing has been heralding a new economic vision. The key elements: Grimy factories will give way to renewable-energy industries and a growing service sector; Chinese consumers, rather than stretched Americans and Europeans, will underpin demand; and instead of churning out me-too goods for little profit, Chinese companies are supposed to create innovative products based on home-grown technologies.

As President Barack Obama prepares for his first state visit to the mainland on Nov. 15 though, some economists are taking a skeptical look at China's evolution. While Beijing has honored many of the market-opening commitments it made to join the World Trade Organization in 2001, promised reforms such as allowing greater foreign investment in telecommunications and financial services have stalled. Over the past three years a steady stream of directives flowing from a raft of min-

CHINA TRIUMPHANT?

China is making huge strides in sophisticated industries, but skeptics say many of its products rely on imported technology and question whether mainland companies are innovative enough to compete overseas. A few examples:

AUTOS

BYD, Chery, and Geely dominate China's small-car market and generate lots of buzz about their electric vehicles. But they lag foreign brands in bigger models, and their cars may not meet Western quality and safety standards.

AIRLINERS

China's first commercial jet, the 90-seat ARJ21, hits the market next year, and a 190-seater is due by 2016. But experts say they're based on older McDonnell Douglas designs and that foreigners will supply the core systems.

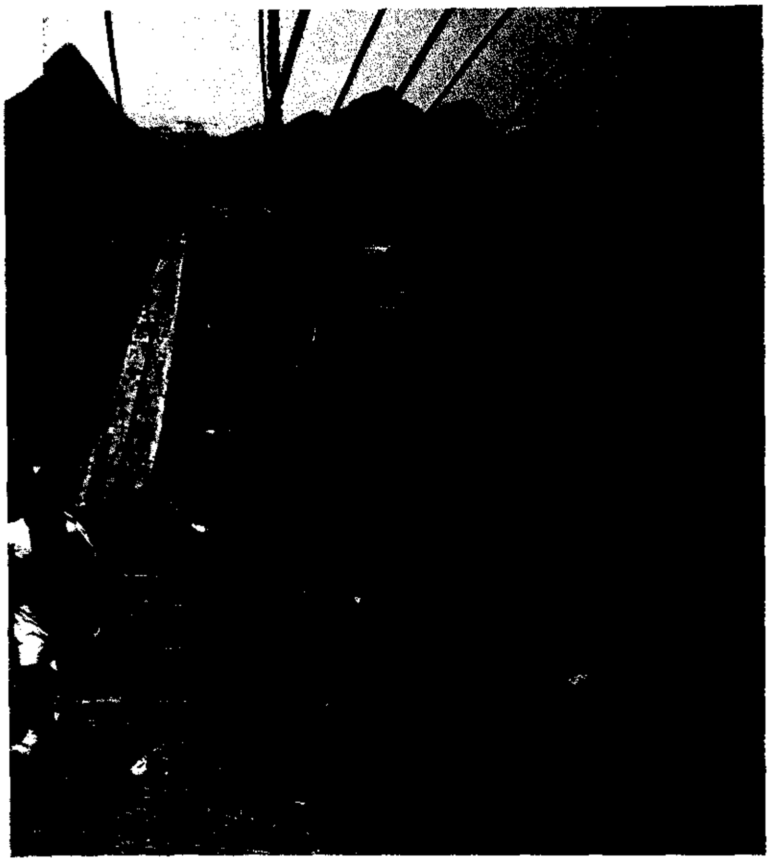
CHIPS

The mainland has built eight silicon wafer plants since 2005. But last winter 60% of capacity was idle, and few Chinese chipmakers have ever been profitable. Moreover, China's technology is at least two generations behind global leaders.

SOLAR

China makes 35% of the world's solar cells, but it suffers from massive overcapacity. And its strength is in an older technology using polysilicon, while the market is shifting to harder-to-make cells based on flexible materials.

Data: iSuppli, Frost & Sullivan, *BusinessWeek*



Guizhou Province: Infrastructure remains a big driver of China's GDP growth

The C919, due out in 2016, is meant to directly challenge Boeing and Airbus

ZHOU LEI/XINHUA/XINHUA PRESS/CORBIS

istries and the National Development & Reform Commission—successor to the old central planning agency—have tightened the state's grip on the economy. In June, for example, the commission ordered that wherever possible only goods made by Chinese-owned companies be used in any project funded by the government.

The state's comeback is easy to spot. The vast majority of new loans are now going to government-controlled enterprises, for instance, while less than 20% end up at small and midsize firms, which tend to be private, Standard Chartered Bank estimates. And in strategic industries from wind turbines to nuclear power generators, Beijing is favoring its national champions and trying to whittle down the role of foreign companies. "They are rolling up the red carpet," says Joerg Wuttke, president of the European Chamber in China, which recently released a 584-page white paper arguing that China has hit the brakes on opening its economy. Says a U.S. trade official: "China's focus seems to have shifted from accelerating market reforms toward a more state-controlled model. It is very worrying."

Besides aggravating trade frictions, the Communist Party's renewed penchant for control could undermine China's competitiveness overseas. Clamping down on the ability of foreigners to do business in China would make life easier for Chinese companies at home; the downside is that it would let them avoid honing the skills needed to succeed outside the mainland. And funneling funds to state companies and connected insiders leaves creative entrepreneurs starved for capital. "The government wants to stimulate innovation and job creation but is doing the opposite," says economist Xu Xiaonian at the China Europe International Business School in Shanghai.

There are already signs that Beijing's policies are undermining the transition to a more balanced economy that might propel growth around the world. Over the past decade, consumer spending—what should be the mainstay of a new Chinese economy—has slumped from 45% of gross domestic product to 35% and now stands at about half the U.S. level. A full 88% of this year's GDP growth, Morgan Stanley's Roach estimates, will come from the usual source: fixed-asset investment in infrastructure, real estate, and yet more production lines. In the past two years, Chinese steel capacity has swelled by a third, and the mainland's idle capacity this year will nearly equal the combined steel output of the U.S. and Japan. "If anything, we are seeing a retreat to the old formula of support for large-scale manufacturing and exports," says David Hoffman, China managing director for the Conference Board, a business group.

For a glimpse of what may lie ahead if China fails to transform its economy, head to the southern city of Dongguan. The thousands of factories in the Pearl River Delta industrial hub churn out televisions, furniture, toys, and a seemingly infinite number of other products for consumers worldwide. But with China's exports down 15% in September—the 11th consecutive month of decline—Dongguan is reeling. In the Changping district, once dubbed "little Hong Kong," shuttered factories are overgrown with weeds. The karaoke bars and restaurants, which once catered to the thousands of Hong Kong and Taiwanese managers who have fled, are quiet. Sure, the economy of Guangdong Province is on track for 9% growth this year, but that's due mainly to massive government spending on public works, such as an airport expansion and a nuclear power station. "What Guangdong is facing, all of China is facing," says Wang Yiyang, vice-director of Guangdong's development research center, an arm of the provincial government. "We have to find new sources of competitiveness."

HOW TO PLAY IT 068

In response, Guangdong is launching a crash restructuring that the provincial Party boss calls "emptying the cage and changing the birds." Dongguan and eight other Delta cities are moving low-wage factories into new industrial zones 50 miles or more to the north in poorer parts of the province. Greener industries, such as biopharmaceuticals, renewable energy, and information technology, are to replace them. But hopes for a surge in foreign investment have been dashed by the global recession. So Guangdong is courting state-owned companies from elsewhere in China and pressing local enterprises to become more innovative.

In pockets across the country, officials have made far more progress toward the new economic vision. China is aggressively promoting wind power, greener solid-state lighting, and high-speed trains. Shanghai, Beijing, and dozens of other cities are building vast subway networks to complement the highways already in place. To persuade citizens to spend more and save less, Beijing is expanding public health care and subsidizing small cars and electric appliances. Millions of small private companies have sprouted, and hulking state industries that provided cradle-to-grave benefits have been downsized. Cities and provinces are boosting research spending, retraining workers, and courting investment in new industries such as biotechnology, which is attracting top Chinese scientists from the U.S. "China's growth seems unstoppable," says Rao Yi, a former Northwestern University neuroscientist and now dean of Beijing University's life-sciences school.

NO INCUBATOR OF INNOVATION

China has a long way to go, though, in innovation. The mainland has dramatically boosted research spending and boasts the world's biggest pool of science and engineering graduates. But aside from Internet games, the country creates few breakthrough products, due in no small measure to the perennial problem of rampant counterfeiting. China last year exported $416 billion worth of high-tech goods. But subtract the mainland operations of Taiwanese contract manufacturers and the likes of Nokia, Samsung, and Hewlett-Packard, and China is an electronics lightweight. Beyond Tsingtao beer and low-end Haier refrigerators, "China has zilch brand presence in the U.S.," says Kenneth J. DeWoskin, director of the China Research & Insight Center at Deloitte & Touche. Instead, most mainland companies mine existing technologies and compete on high volume and low cost in commodity goods.

Take cars. For decades, Beijing has sought to shore up the industry. But Volkswagen, Toyota, Buick, and other foreign brands dominate in midsize sedans and SUVs. Domestic carmakers such as BYD Auto, Geely, and Chery have thrived by developing subcompacts that sell for as little as $4,400. They're now China's great hope in electrics and hybrids. Beijing, meanwhile, is ramping up support. To meet a goal of producing 500,000 such vehicles by 2011, the Science & Technology Ministry plans to put 60,000 electric buses and taxis on the streets and offer subsidies to buyers in 13 cities.

BYD Auto has generated the most buzz. The Shenzhen company this year expects to sell 400,000 cars, and its parent is one of the world's largest producers of lithium-ion batteries for mobile phones, PCs, and other gadgets. Next year it plans a U.S. launch for the e6, a five-seat electric plug-in with a claimed range of 249 miles. BYD's stock has rocketed so high that fabled investor Warren E. Buffett's 10% stake already has earned him a paper profit of more than $1 billion. BYD vows to be China's largest carmaker by 2015 and overtake Toyota as the world's leading brand by 2025, producing 10 million vehicles a year—half of them for export.

BYD has a long way to go. This year it will be lucky to match its 2008 export record of 8,000 cars, all sold in Russia and developing nations from Africa to Latin America. It says it has delivered only about 100 of its $22,000 F3DM plug-in hybrids in China this year—far from its sales target of 4,000. BYD's biggest advantage? It's not design, cutting-edge technol-

CRADLE OF A GREEN REVOLUTION

Dalian's experiment in innovation may point the way for all of China

By Pete Engardio

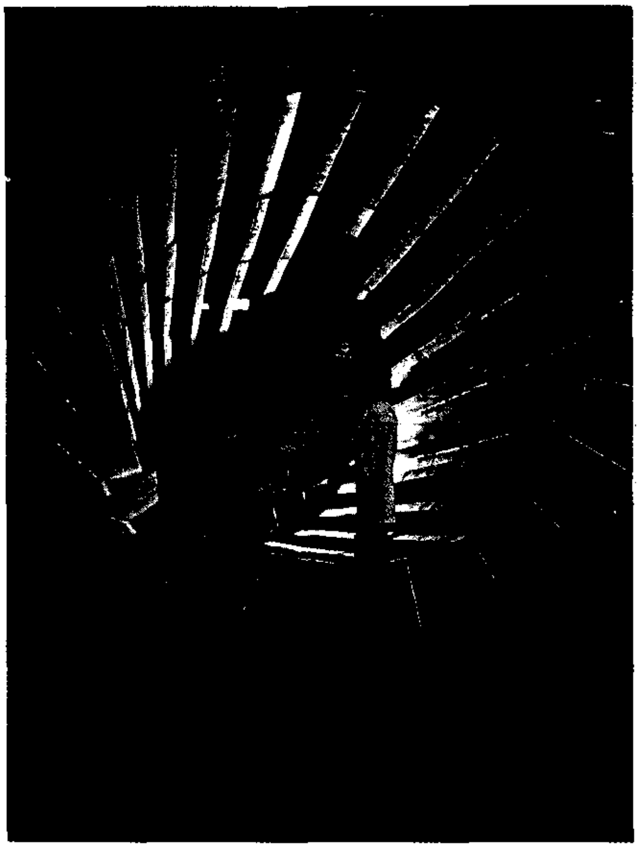
DALIAN

In a nation known for pollution-choked cities and countless smoke-belching factories, Dalian, on China's rugged northeast coast, offers a pleasant respite. Fresh green spaces abound in the hilly city of 6 million that is often compared with San Francisco. Xia Deren, a former university dean and now Dalian's urbane Communist Party chief, waves his arm toward a leafy district of low-rise office buildings outside his window. Fifteen years ago, he says, "the area where we are now sitting was filled with chemical plants." Those factories, and many others that once ringed the city's picturesque harbor, have been shut or relocated, replaced by rapidly expanding software houses, green-technology plants, and service companies that are becoming Dalian's new economic pillars.

Cities from Chongqing in the southwest to Tianjin and Shanghai in the east are attempting similar makeovers. But while Dalian's transformation is hardly complete—just up the coast, a petrochemical company is building a controversial $700 million plant—it may be furthest along in implementing Beijing's vision of the economic future: replacing sooty, low-skill factories with innovative green industries. "We need to change the way our economy grows and embark on a new road of industrialization," says Xia.

Dalian's economy has been propelled largely by companies that do outsourced work for Japan and other Asian neighbors. The city boasts 400 software companies accounting for $1 billion in annual exports and 60,000 jobs—a figure that's expected to reach 200,000 in three years. Oracle, Fidelity Investments, Nippon Telephone & Telegraph, Citigroup, and Minolta have all invested in Dalian, and Intel is building its first Asian silicon wafer fabrication plant just outside the city.

Local officials are pioneering new strategies to spur innovation. They stress collaborations among universities, government



Devotion President Ma has shifted his company's focus to biofuels

PAUL HU/ASSIGNMENT ASIA

self-sufficient, producing everything itself," says Nathan K. Smith, aerospace analyst at market research firm Frost & Sullivan. "But it simply doesn't have the capabilities to develop these aircraft without Western technology." The prospect of Comac competing with Boeing and Airbus outside China even two decades from now, says Smith, "is a long shot." Comac declined interview requests.

Some Chinese industrial policies have flopped. Beijing has long viewed semiconductor manufacturing as a key industry, for example, and eight new silicon wafer plants—some heavily subsidized—have been built just since 2005. The aim was to start out competing as low-cost contract manufacturers for foreign chip design firms. But China's wafer factories rely on technologies that are at least two generations behind those of Taiwan, the U.S., Japan, and South Korea, and few have ever been profitable. At the nadir of the recession last winter, 60% of China's capacity sat idle. But with next-generation wafer plants costing $3 billion and up, a major shakeout looms, says Len Jelinek, semiconductor analyst for market research firm iSuppli. "Most Chinese companies don't have the technology and the money to invest in research and development to stay in the game," he says.

Of course, China has plenty of smart entrepreneurs who are steering their companies in new directions. They're tapping the mainland's engineering talent, stressing design, and reorienting old-line manufacturing operations to unearth new opportunities. Guangzhou's Devotion group typifies the shift. The 17-year-old company's primary business—making huge diesel-fired boilers for factories and big buildings—has been hit by the slowdown, rising fuel costs, and growing government efforts to reduce air pollution. Sales plunged 45% in the first half, and its Singapore-listed shares trade below their 2003 offering price.

So Devotion has shifted its focus to biofuels and the boilers that burn them. Outside its headquarters are piles of broken wooden pallets, containers filled with corn and rice husks, a patch of elephant grass (a fuel source that can grow 10 feet high in a few weeks), and a hulking refinery that turns such materials into biogas, oil, and flammable pellets. Devotion offers to install boilers for free and says it makes its money on long-term contracts to sell the biofuels. The company says it now has 30 biofuel customers and aims to triple sales, to $600 million, within five years, with most of the increase coming from new-energy products and services. But with diesel boilers accounting for 90% of sales, it will have to ride out tough times. The biofuel business "is still small," concedes Devotion's burly president, Ma Ge.

Given China's many signs of progress, it's easy to forget that it remains an underdeveloped economy facing huge challenges. Yes, it has an immense, youthful population, gifted entrepreneurs and scientists, ambitious officials—and lots of money. So it's likely Beijing will someday get the formula right. But China's economic reforms are now three decades in the making. That's several years longer than Mao Zedong and his loyalists spent imposing their extreme brand of socialism. "Japan and South Korea took 30 years to make a similar transformation" to an economy driven by innovation, consumer spending, and services, says Guangdong Academy of Social Sciences economist Ding Li. "Our expectations can't be too high." But expectations of China's arrival as a superpower already are high both at home and abroad. The longer Beijing waits to update its tired growth formula, the longer it will take for China to fulfill that destiny. |BW|

—With Huang Zhe in Beijing

Business Exchange

Read, save, and add content on BW's new Web 2.0 topic network

Increasing Protectionism

In separate papers published this autumn, the U.S.-China Business Council and the European Chamber of Commerce in China both identified rising protectionism and economic nationalism as pressing concerns for foreign companies doing business in the mainland. Some markets are effectively closed to international investors, while in others, laws and regulations are selectively enforced to favor domestic companies at the expense of foreign-owned rivals. And while China's immense stimulus package has created opportunities for a few foreigners, especially those involved in infrastructure, most of the funding has gone to mainland companies.

To view the papers, go to **bx.businessweek.com/china-business/reference/**

CHINA'S END RUN AROUND THE U.S.

As more free-trade deals exclude America, Beijing could dominate a new Asian trade bloc

By Dexter Roberts and Pete Engardio

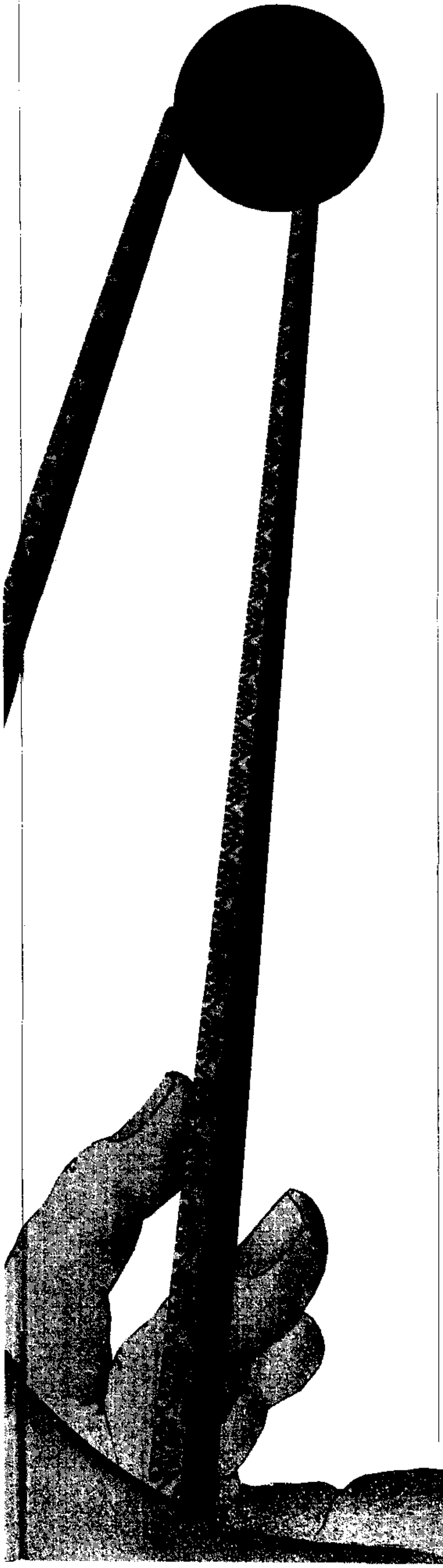
BEIJING

President Barack Obama makes his first state visit to East Asia on Nov. 13-19. He'll start off in Tokyo, attend a meeting of the Asia-Pacific Economic Cooperation forum in Singapore, travel to Shanghai and Beijing, then finish up in Seoul.

It's a cover-the-waterfront trip, but the focus is on China, America's key trading partner and rival. The Obama team will express its concern that Beijing aims to boost locally owned companies, from commercial aircraft makers to express delivery services, all at the expense of foreign competitors. Washington also wants China, which has more than $2 trillion in foreign reserves, to let the yuan appreciate against the dollar. Finally, Obama and top Cabinet officials will press Beijing to stoke consumer demand at home and rely less on exports to drive growth. Rebalancing the economies of China and other Asia nations "is perhaps the most important thing we can do to restore growth and jobs in the U.S.," explains one senior White House official.

Beijing will likely respond by playing up the country's accomplishments: a huge stimulus package that pumped up spending at home and kept the world from sliding deeper into recession; signs of an increase in consumption; and a modest appreciation of the yuan over the last five years. China's ministers will also point out that Washington has its own work to do, especially in cutting the U.S. budget deficit, bolstering the dollar, and devising regulations to prevent another blowout.

What happens in Beijing next week will undoubtedly be important to U.S.-China trade relations. But trade developments throughout Asia will likely affect the American position in the region as much as, or more than, those meetings in Beijing. Even while it keeps up the dialogue with Washington, China is essentially doing an end run around the U.S. in Asia by pursuing a bewildering variety of free-trade pacts with its neighbors. "What China is doing is very smart and logical," says Linda Menghetti, vice-president of the Emergency Committee for American Trade, a Washington group representing U.S. multinationals. The White House, transfixed by problems at home and its own diplomatic dance with China, trails its rival in sewing up trade deals. The result could be a trade bloc dominated by the mainland.



China's trade diplomats have been exceptionally busy. Next year a deal to drop most duties on farm and manufactured goods goes into effect among China and 10 Southeast Asian nations. A landmark free-trade agreement between China and Taiwan is under discussion, while a financial-services pact with the island could be announced soon. Talks on liberalizing trade terms with Seoul and the Persian Gulf states are under way. China Premier Wen Jiabao just visited Egypt, where the Chinese announced a plan to give $5 billion in low-interest loans and export credits to Africa. In October, Vice-Premier Li Keqiang traveled Down Under to mend relations with commodity-rich Australia and discuss a new free-trade deal with New Zealand. With less success, Beijing has pushed for a regional currency that would weaken reliance on the dollar and increase the role of the yuan.

Why all the hustle? China's total trade volumes are expected to drop 20% this year largely because of the U.S. recession. Beijing has to keep exports growing to keep workers employed, and it needs commodities to turn into finished goods. China also needs other nations as customers and suppliers—if not the U.S., then Korea, Japan, Australia, and others will do.

Chinese companies aren't complaining. After the Southeast Asian trade bloc decided to shed agricultural tariffs and ease manufacturing and property investment rules for Chinese companies, for example, Nanning-based Guangxi State Farms Group signed deals worth more than $620 million in the region. The U.S. has been talking about joining the same trade group since 2002. The delay puts American companies at a disadvantage, says Karan Bhatia, a former U.S. trade negotiator who now is General Electric's vice-president and senior counsel for international law.

CHANGING PERCEPTIONS

Most manufactured goods made in Southeast Asia will now enter China duty-free. But goods shipped from the U.S. will still face average duties of 9%. "That is a meaningful differential," Bhatia says. Much like Nafta, which prompted many global companies to produce in Mexico in order to export duty-free to America, many U.S. manufacturers will have to go to Southeast Asia to have better access to China. That would be bad for U.S. exports.

Obama is aiming to change the perception of American indifference. Trade issues will be on the agenda in Seoul and Tokyo as well as in Beijing, and Obama's team will include top economic officials Treasury Secretary Timothy Geithner, Trade Representative Ron Kirk, and Commerce Secretary Gary Locke, as well as Energy Secretary Steven Chu.

"Japan can't only rely on relations with the U.S., because Washington's global influence has diminished," says one economist

The Obama visit, meanwhile, may yield some movement on a U.S. pact with New Zealand and Chile. But important free-trade deals with Taiwan and Korea have been held up. One reason is the U.S. approach to these agreements. In its trade talks, the U.S. typically tries for universal, all-in-one deals that cover not only lower tariffs but also services, intellectual property rights, government procurement rules, and even labor and environmental codes. Initiatives by China and other Asian nations, in contrast, focus on simpler, narrower goals, such as a cut in tariffs or easing investment rules.

The message, says White House foreign policy spokesman Ben Rhodes, is that "the President is very committed to being competitive in this region." The Administration also knows that American executives are getting nervous. "What the companies are expressing is a strong interest in the U.S. being engaged in [Asia]," says the senior White House official. "That is our position, not to sit on the sidelines."

Rather than bringing concrete proposals, though, Obama is likely to talk in generalities, says Ernest Bower,

ILLUSTRATION BY BRIAN STAUFFER

Southeast Asia director at Washington's Center for Strategic & International Studies. "We are coming without any goodies in our basket," he adds.

The change in thinking in Tokyo and Seoul illustrates Washington's problem. In Japan, new Prime Minister Yukio Hatoyama aims to forge a trade group with China and South Korea. Rising exports to China have helped Japan's economy survive a plunge in trade with America. "There's a consensus among policymakers that Japan can't only rely on relations with the U.S., because Washington's global influence has diminished," says Keio University economist Masaru Kaneko.

It's a similar story with Korea: In 2002 the U.S. took 20% of Korean exports. In the first 10 months of 2009 the American share dropped to 10.5%, while China accounted for nearly 24%. No breakthroughs in U.S. trade talks with Korea are expected. "I'm sure we will hear lip service about moving the Free Trade Agreement forward," says Lee Si Wook, a trade expert at the Korea Development Institute, a government think tank. "But actions will be lacking." | BW |

–With Moon Ihlwan in Seoul, Frederik Balfour in Hong Kong, Kenji Hall in Tokyo, and Jane Sasseen and Steve LeVine in Washington

A SLOG IN CHINA FOR FOREIGN INSURERS

How mainland rules are giving an edge to domestic rivals

By Frederik Balfour

When insurer AIA moved back into its gray stone colonial headquarters on Shanghai's waterfront Bund in 1998, it marked the return of foreign insurance companies to China after their ejection nearly five decades earlier. Since then the floodgates have opened as Cigna, AXA, Allianz, and dozens more have set up shop on the mainland, aiming to tap a market of 1.3 billion people with few options for life insurance.

As it turns out, their optimism may have been overblown. While there's vast potential—life insurance premiums represent just 2.2% of China's gross domestic product, vs. 13.6% in Taiwan and 9.9% in Hong Kong—cracking the market has been tough. In June foreign companies took in only 4.7% of premiums paid in China. Their revenues have been on the rise, but that's a big step backwards in share: In 2007 foreigners had 8% of premiums, according to the China Insurance Regulatory Commission.

4.7%

Market share of foreign companies in China's life-insurance market

Data: China Insurance Regulatory Commission

The newcomers underestimated the strength of China's incumbents. China Life, Ping An, and other domestic insurers enjoy tremendous name recognition. And they can have nationwide licenses, while foreigners need separate permission for every new city or province where they want to do business. "There is clearly an uneven playing field," says Gary Bennett, China chief for New York Life, which has a joint venture with Qingdao-based appliance maker Haier Group. "It's a fact that there is some level of protectionism." While Beijing doesn't explicitly acknowledge that, some mainlanders say domestic insurers need a leg up to survive. "There is a general sense that this industry is in its infant stage and needs to be protected," says Jin Feng, a former government official who now runs CNinsure, a Guangzhou insurance brokerage listed on Nasdaq.

ODD PAIRINGS

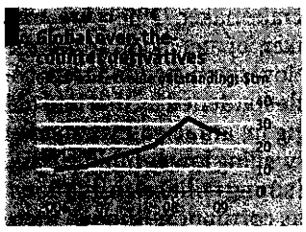
Then there's the problem of joint ventures. Virtually all foreign insurers in China must work with local partners, and these often lack any experience in the industry. Canada's Manulife Financial, for instance, is teamed up with state oil company Sinochem, while the U.K.'s Aviva is partnered with food conglomerate Cofco. Relations in joint ventures can be strained under any circumstances, and in insurance—where it may take a decade or more before profits start flowing—it's doubly difficult. "There are frictions between the partners when more cash is required for expansion," says UBS analyst Kenneth Lo.

A further concern for the new entrants is the underdeveloped state of China's capital markets. The bond market is small and illiquid, and it often takes good connections to get in on primary issues. So the foreigners have a harder time than their domestic rivals in buying assets to assure the predictable income streams needed to meet payments on policies years from now. "It's an ongoing problem," says Simon Machell, Aviva's Asia chief, "of taking on liabilities of up to 25 years when the availability of long-dated assets in China is quite limited."

Derivatives

Options have a future

Economies need derivatives, but reform is justified



KING HAMMURABI of Mesopotamia regulated the use of derivatives almost 4,000 years ago. The Japanese have been trading rice futures since around 1650. That contracts based on the price of some commodity or asset have been around for about as long as mankind has been trading indicates that they are pretty useful.

Derivatives enable individuals and companies to insure themselves against risk. Just as they fear the destruction of their belongings by fire or theft, businesses may also be concerned that exchange- or interest-rate movements may turn a good idea into a lossmaker. Derivatives allow them to lessen that risk. But someone needs to take the other side of the bargain, and that usually requires a speculator. Some of those speculators will go bust. Those who insure against fire and theft can set premiums on the basis of decades of experience; financial markets are inherently less predictable.

In the latest crisis, the problem was that investors erroneously believed property prices were quite predictable and built a whole edifice of derivatives on the back of the American housing market. To make matters worse, regulators wrongly believed that the use of derivatives, and the bundling of property loans into securities, had spread risk evenly throughout the system. They accordingly allowed banks to gear up their balance-sheets to a greater extent than before. In fact, much of the risk of a property crash still resided in the banks, and the complex nature of derivatives made their exposure very hard to calculate, leading to a loss of confidence in almost all of them.

Derivatives' tendency to magnify problems has led to calls for regulators to ban some types. Their economic usefulness, it is argued, is far outweighed by their capacity to create systemic risk. Similar arguments were advanced two decades ago, when equity futures may have contributed to the Black Monday crash of 1987 and British local councils lost money in the obscure world of interest-rate swaps.

But after a few modest reforms, equity and interest-rate futures traded without incident, even through the latest crisis. And the same could be true of the more complex stuff. Even the much-maligned credit default swaps have their uses; by allowing investors to separate default risk from the other risks involved in buying bonds, they potentially reduce the cost of capital for business. Nor is a ban likely to achieve its aims. Congress banned onion futures in the 1950s on the ground that speculators were driving the price of the vegetable. The initiative ended in tears: onion prices since have been no less volatile than they were before.

Clearing and present danger

More modest reform, however, is needed (see pages 74-76). Proposed legislation to encourage the trading of more derivatives on exchanges or through central counterparties deserves support, for it would make it easier to monitor what market participants were doing. Capital requirements need to be increased, so derivatives cannot be used as an easy way for banks to get around restrictions on gearing.

The trickiest issue concerns exemptions for end-users, such as manufacturers. Allowing companies to hedge their risks is the whole point of the instrument. But if the rules favour them over financial companies, trading will tend to migrate towards them, and away from banks. AIG, once the world's biggest insurer, thought it was making "easy money" by using its strong credit rating to sell protection against credit defaults; in fact, it was digging its own grave.

These reforms may raise the price of using derivatives, but that would not necessarily be a bad thing. When fire and theft premiums rise, those who really need insurance still pay up. ■

Music industry

How to sink pirates

The decline of music piracy holds lessons for other industries

YOU open a window on your computer's screen. You type in the name of a cheesy song from the 1980s. A list of results appears. You double-click on one of them, and within a few seconds the song is playing. This is what it was like to use Napster a decade ago; and it is also how Spotify, another free online-music service, works today. The difference? Napster was an illegal file-sharing service that was shut down by the courts. Spotify, by contrast, is an entirely legal, free service supported by advertising. This shows how much things have changed in the world of online music in the past decade. It also explains why online music piracy may at last be in decline.

For most of the past decade the music industry focused on litigation to try to prevent piracy. Over the years the Recording Industry Association of America (RIAA) has accused 18,000 internet users of engaging in illegal file-sharing. Most of them settled, though two cases went to court this year. In both cases the defendants (a single mother and a student) lost and were ordered to pay damages (of $1.92m and $675,000 respectively). But the industry has realised that such cases encourage the publication of embarrassing headlines more than they dis- ▸▸

Oracle and Sun Microsystems

Merger interruptus

Regulators may block a big technology tie-up, but their case is not convincing

FOR a brief period many hoped that trustbusters in Europe and America would start playing in tune. During the eight years of the Bush administration, the European Commission's competition police took a notably more activist approach than their American counterparts. With a new man in the White House, regulators in Washington let it be known that they intended to act with greater vigilance.

This apparent meeting of minds has not lasted long. On November 9th it emerged that regulators in Brussels object to the proposed $7.4 billion purchase of Sun Microsystems, a troubled maker of computer hardware, by Oracle, a software giant. That puts them at odds with America's Department of Justice, which gave its approval to the tie-up in August. Observers now fear the outbreak of a transatlantic row over antitrust similar to the one that broke out in 2001, when Europe blocked a union between two conglomerates, General Electric (GE) and Honeywell.

Whether the case will indeed turn into a full-blown conflict between Brussels and Washington is not certain. What is clear, however, is that the commission and Oracle will have a hard time finding common ground. Oracle is the world's biggest seller of proprietary (meaning "paid for") database software, with a market share of nearly 50%. Sun owns MySQL, the most widely used open-source database program—"a particularly important competitive force", according to the commission.

To Oracle, the argument reveals a "profound misunderstanding" of both database competition and open-source dynamics. For one thing, it says, MySQL and Oracle's databases do not compete: the former is a relatively simple program used by many websites, while the latter is complex software that underpins corporate applications. Second, since MySQL is open-source, anyone can use the program's underlying recipe. If Oracle were to give up on it, other firms would continue its development.

The facts appear to be on Oracle's side. It is hard to find anyone in the technology business who is prepared to argue that MySQL and Oracle really compete—or ever will. The commission is on firmer ground when it argues that the way MySQL is licensed would allow Oracle some control over commercial use of the program. Although MySQL and its underlying recipe are available free, any added code built around the open-source product must also be made open source. Most firms that develop products on top of MySQL prefer to buy a commercial licence that does not come with this obligation. This they obtain from the copyright holder, which would be Oracle. Because of the success of this "dual-licensing" set-up, a strong alternative to MySQL is unlikely to emerge.

It is easy to see why Oracle has refused to cave in, despite the fact that Sun is continuing to lose business. Oracle appears to be betting that the commission will stop short of blocking the merger. Neelie Kroes, the competition commissioner, is on her way out. Some within the commission may become nervous, remembering the GE/Honeywell case, where its legal reasoning was later criticised by the European Court of First Instance. Still, Oracle would probably accept a deal to spin off MySQL should the commission demand this as a remedy before January 19th, by which time a decision must be made.

It is more difficult to understand why Ms Kroes has decided to push the case. Recently she has shown signs of wanting to clear the shelves before her departure. She is, for instance, about to finalise a settlement with Microsoft that many describe as disappointing, given how tough she has been with the world's biggest software firm in recent years. Perhaps Oracle has managed to antagonise Ms Kroes by not taking her seriously and accusing the commission of destroying jobs by holding up the merger. At any rate, her successful tenure as Europe's chief trustbuster could end on some jarring notes. ■

Japan as number one

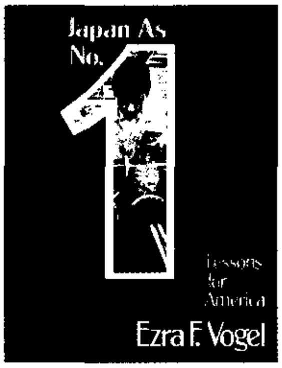
Land of the setting sun

TOKYO

Japan's economy was on course to surpass America's. What happened?

IT LEFT American executives quaking in their loafers and cheered a generation of Japanese salarymen. "The extent of Japanese superiority over the United States in industrial competitiveness is underpublicised," trumpeted Ezra Vogel of Harvard University 30 years ago in "Japan as Number One", which became one of the most-discussed business books of its time.

The world's second-largest economy had surpassed America in gross national product per person according to some measures, and looked on course to overtake it. "Vogel's book helps explain why Japan is the most dynamic of all modern industrial nations," gushed *Foreign Affairs*. America was mired in stagflation, with an unemployment rate nearing double digits. Japan seemed to be the better bet.



Soon to be number three

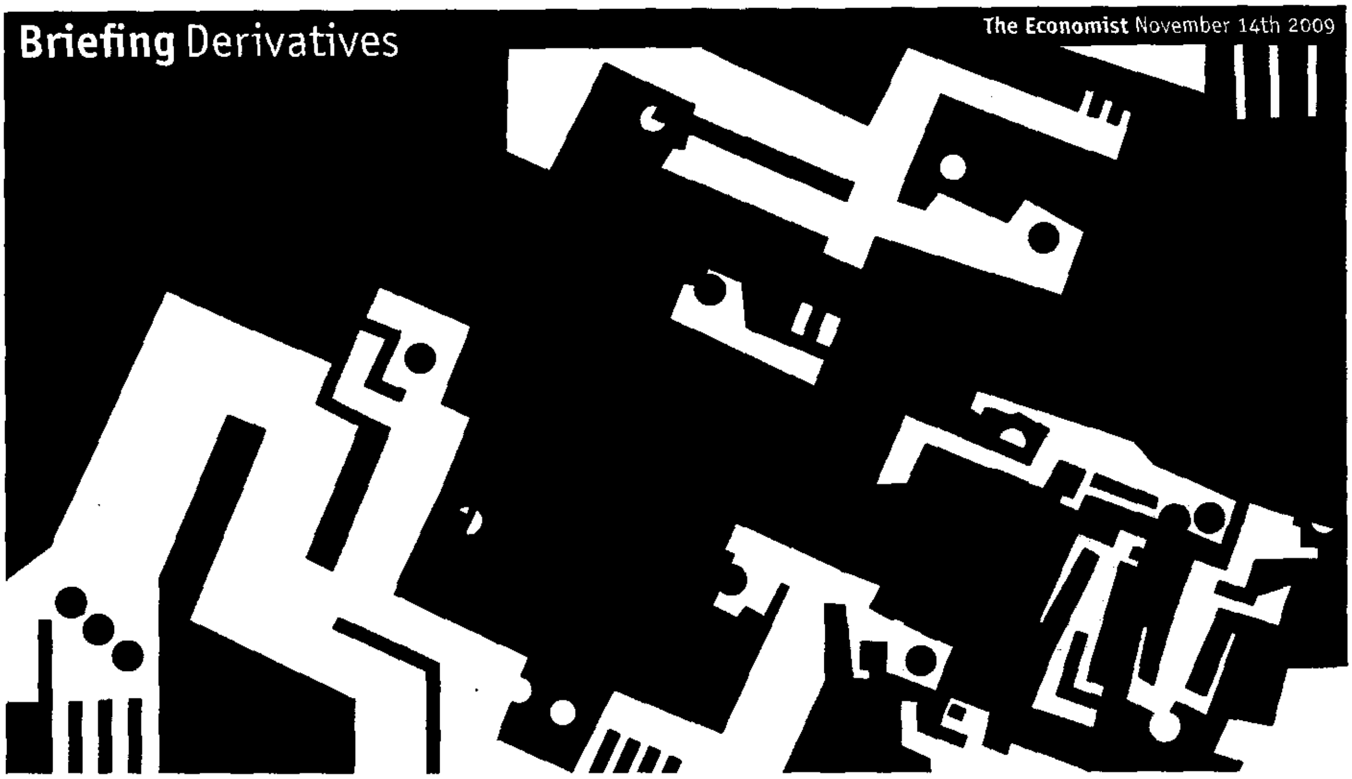
Yet things didn't quite work out the way Professor Vogel expected. Japanese industrial production rose by 50% in the decade after 1980—a remarkable trajectory for a country crammed into an area the size of Montana. But growth was driven by financial leverage and overinvestment. Property and share prices bubbled, rising as much as sixfold.

The bubble's collapse, beginning 20 years ago this December, led to almost two decades of economic doldrums. It took 15 years for industrial production to surpass the 1991 peak. In the current crisis it collapsed to levels last seen in the 1980s. In time America's fearful "Japan bashing" gave way to sniggering, then indifference. Last month a poll of market professionals by Bloomberg, a news provider, put Tokyo last among several big cities as a financial capital. In the 1980s all of the world's top ten banks measured by deposits were Japanese.

Why didn't Japanese business regain momentum? Companies, accustomed to being protected, were too slow to change, says Karel Van Wolferen, author of "The Enigma of Japanese Power", published 20 years ago this year. Steven Vogel of the University of California in Berkeley (and Professor Vogel's son), blames regulators for failing to clean up the banking system until long after the crash.

His father had argued in 1979 that Japan set many examples to America: good labour relations, low crime, excellent schools and elite bureaucrats with long time horizons. "And the US did learn," particularly in manufacturing, he says today from retirement in Cambridge, Massachusetts. Yet change is needed in Japan, he admits. A system geared for high growth has been unable to adapt.

Though it is still the second-largest economy, Japan may well lose that title to China in 2010. Many are now cooing about China's growth. But the lesson of Japan is that nothing is inevitable.



Over the counter, out of sight

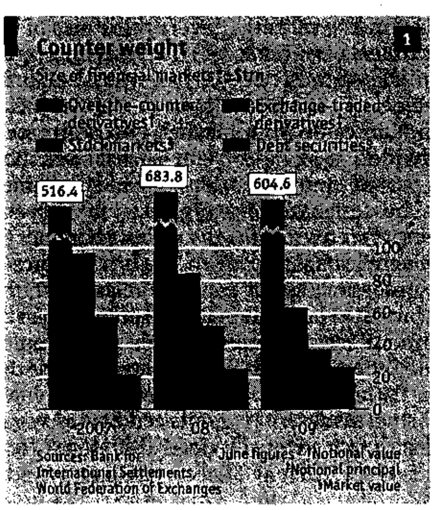
Derivatives are extraordinarily useful—as well as complex, dangerous if misused and implicitly subsidised. No wonder regulators are taking a close look

IN 1958 American onion farmers, blaming speculators for the volatility of their crops' prices, lobbied a congressman from Michigan named Gerald Ford to ban trading in onion futures. Supported by the president-to-be, they got their way. Onion futures have been prohibited ever since.

Futures are agreements to trade something at a set price at a given date. They are perhaps the simplest example of a derivative, a contract whose value is "derived" from the price of a commodity or another asset. Derivatives continue to be vilified, usually when someone loses a lot of money. Orange County and Procter & Gamble lost fortunes on them in the 1990s. They were at the core of Enron's failure. And in September 2008 they brought American International Group (AIG), a mighty insurer, to its knees. Its fetish for credit default swaps (CDSs), a type of derivative that insures lenders against borrowers' going bust, led it to guarantee at least $400 billion-worth of other companies' loans—including those of Lehman Brothers. The American government forked out $180 billion to save AIG from collapse.

Every catastrophe brings calls for restrictions on derivatives. This year Joseph Stiglitz, a Nobel economics laureate, has said that their use by the world's largest banks should be outlawed. But derivatives have defenders too. Used carefully, they are an excellent—some would say indispensable—tool of risk-management. Myron Scholes, another Nobel prize-winner, says a ban would be a "Luddite response that takes financial markets back decades."

Because of the mayhem of the past year or so, lawmakers in America and Europe are on the point of giving derivatives markets their biggest shake-up since the 1970s. For the world's biggest banks, billions of dollars are at stake. For taxpayers, the stakes are just as high.



Derivatives come in many shapes. Besides futures, there are options (the right, but not the obligation, to buy or sell at a given price), forwards (cousins of futures, not traded on exchanges) and swaps (exchanging one lot of obligations for another, such as variable for fixed interest payments). They can be based on pretty much anything, as long as two parties are willing to trade risks and can agree on a price: commodities, currencies, shares or bonds. Derivatives create leverage too. Contracts are sealed with initial payments that are a small fraction of the potential gain or loss.

In the main, businesses use derivatives to shift risks to other firms, chiefly banks, that are willing to bear them. An airline worried about fuel prices can limit or fix its bills. A bank concerned about its credit exposure to the airline can pass some of its default risk to other banks without selling the underlying loans. About 95% of the world's 500 biggest companies use derivatives. A lack of them can be costly. "The absence of derivatives in iron-ore markets makes negotiations between Australian suppliers and Chinese buyers very confrontational," says Philip Killicoat of Credit Suisse. Earlier this year Rio Tinto's chief negotiator, Stern Hu, was arrested in China during hard bargaining over prices. And the futures ban has not stopped the price of onions from going up and down.

Derivatives have a long history, stretching back thousands of years. In the 17th century the Japanese traded simple rice futures in Osaka and the Dutch bought and sold derivatives in Amsterdam. But trading in financial derivatives really took off only in the 1970s. The fluctuations in currencies ▸▸

▸ and interest rates after the collapse of the Bretton Woods system gave a push to demand. The option-pricing formula developed by Fischer Black and Mr Scholes, plus advances in computing power, made valuing derivatives much easier. Regulators encouraged them, too. Thrift Bulletin 13, issued by the Federal Home Loan Bank System in 1989, obliged American thrifts to hedge their interest-rate risk.

Derivatives are bought and sold in two ways. Contracts with standardised terms are traded on exchanges. Tailored varieties are bought "over the counter" (OTC) from big "dealer" banks. These banks support the OTC market by hedging their clients' risks with each other or on an exchange.

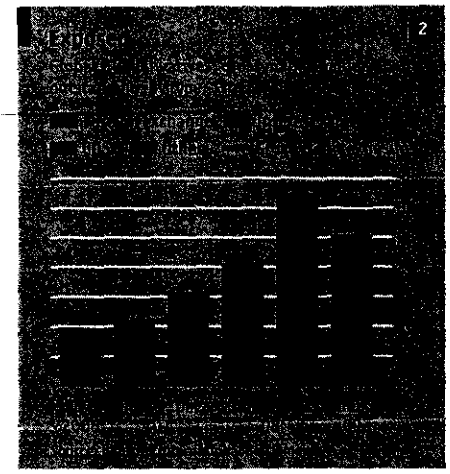
The OTC market dwarfs exchange trading (see chart 1 on the previous page). Estimating its size, however, demands caution. In figures published this week the Bank for International Settlements, the central bankers' central bank, puts its "notional" value at $604.6 trillion. But "those numbers don't appear on anyone's balance sheet," says Barry Epstein, an accountant who specialises in derivatives. For example, the notional value of the CDS market is $36 trillion, says the BIS. But that counts all guaranteed debt—the equivalent, in home insurance, of the value of houses covered rather than premiums paid.

For interest-rate contracts, notional values are even more misleading because they are based on principal amounts; actual obligations depend on interest payments. "Gross market values", which show how much money would change hands if derivative contracts were sold on the reporting date at prevailing prices, are a better guide. But even they are an overstatement. Once banks' claims on each other are stripped out, the residual ("gross credit exposure") is $3.7 trillion, well under 1% of the notional total (see chart 2).

Even so, $3.7 trillion is a large sum. And although derivatives did not cause the financial crisis, they (or their misuse) made it worse. They concentrated risk as much as they spread it, and amplified bad judgments. Their leverage magnified losses on underlying assets like mortgages and crippled even the biggest firms.

Size is not the only reason for regulators' interest. Another is a practice called "close-out netting". Traders of OTC derivatives record their net obligations to each other. On any day, each trader's thousands of bilateral contracts boil down to a single net position owed to or by its counterparties. Netting agreements ensure that if a trader goes bankrupt its position is settled at once, with no need to wait for a court.

"Counterparties to derivative contracts effectively get a super-senior claim to each other's assets," says Craig Pirrong, a finance professor at the University of Houston. For example, in 2008 Goldman Sachs extended credit to CIT, a troubled American lender, but in the form of a "total return swap", a type of derivative, rather than a conventional loan. Now that CIT has filed for bankruptcy, close-out netting puts Goldman up the queue for repayment.



Another problem is that governments implicitly subsidise derivative markets. Dealer banks are so important to the financial system that they cannot be allowed to fail. This government guarantee lowers their cost of borrowing and allows them to provide derivatives more cheaply than they otherwise could. "Even if dealers keep much of the benefit for themselves, everyone is getting derivatives more cheaply at the expense of the taxpayer," says Edward Kane, a professor of finance at Boston College. About one-third of OTC trades require no margin or collateral requirements at all. In effect, firms can get leverage for nothing. On exchanges, traders must put up margin or collateral.

Complexity is a further worry. Richard Bookstaber, who headed market-risk management at Morgan Stanley, says that "complexity cloaks catastrophe". Clients—even supposedly sophisticated ones—do not always understand the risks they are taking on. That's their lookout, you might say, so long as traders do not defraud them and so long as bankrupted clients do not have to be bailed out by the state.

But regulators do have an interest in complexity. It makes valuation difficult: dealers often allocate different values to the same contract. This in turn makes financial accounts more opaque. (Remember Enron.) And the popularity of arcane derivatives has been sustained by "less than lofty purposes", says Mr Bookstaber. For example, under the Basel capital-adequacy rules, when a bank makes a loan to an ordinary company it has to set aside 8% of the loan's value as capital. But for loans to other banks the charge is only 1.6%, because the rules assume banks are more creditworthy. The less they must put aside, the more banks can lend and the more money they can make. This is where CDSs come in handy. A bank overexposed to airlines can use CDSs to share credit risk with other banks and slash the cost of holding the loan. Buying a CDS from AIG, which had a high credit rating, gave banks a similar deal. No wonder they were so eager.

Correction: In last week's article on Japan's technology champions ("Invisible but indispensable") we located Westinghouse and the old heart of the American steel industry in Philadelphia rather than Pittsburgh. Sorry.

Time to clear up

Regulators have a two-part answer to these problems. First, they want more OTC contracts to be cleared by central counterparties (CCPs). A central banker in Europe thinks this will offer "a clear point of entry for authorities to rescue the financial system next time, rather than rummaging through a mire of interlocking obligations." Second, they want more of them to be shifted to exchanges.

The American Treasury has made specific proposals. The European Commission is a couple of steps behind, but promises to "ensure global consistency". To prod derivative markets towards clearing, and ideally trading on exchanges, OTC trades that are not cleared will face a higher capital charge than contracts that are. This may ruin the habitat of more exotic OTC species. Regulators think this is a cost society can bear.

In America supervision would remain split between the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). The SEC would regulate derivatives tied to individual securities and the CFTC much of the rest. For instance, the SEC would oversee CDSs for a single company, whereas the CFTC would regulate those for an index with more than ten names.

CCPs have been around since 1925, when the Chicago Board of Trade Clearing Corporation became the legal counterparty to buyers and sellers of derivative contracts. CCPs take margin and collateral according to the size of trades, so that if a trader defaults, the clearing house should see his counterparty right. They also allow traders to net their positions across all their counterparties, reducing the margin and collateral required.

A sizeable proportion of CCPs are likely to be owned by banks, even though a cap of 20% on their stakes is being mooted in Congress. This year at least three new CCPs have been given approval to clear credit derivatives. Two of them failed to attract significant volume. The other, ICE Trust, is backed by leading dealer banks. In October LCH.Clearnet, an established clearing house, underwent a €330m ($489m) share buyback that happened to boost banks' shareholdings.

To calculate margins, CCPs need to compute a derivative contract's volatility, but for a lot of customised OTC contracts the necessary historical price data do not exist. So the proposed rules require only ▸▸

that "standardised" derivatives be cleared. Clearing CDSs presents another difficulty: because a firm is either bankrupt or not, it is difficult for CCPs to demand margins or collateral that vary smoothly with the risk of the loans insured. The world's largest banks have promised the Federal Reserve they will clear more than 90% of "eligible" interest-rate and credit derivatives by the end of the year. But this includes only derivatives now accepted for clearing.

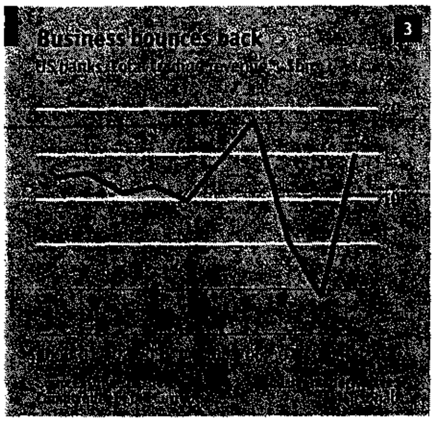
Deciding what else should be cleared will be fraught. Some argue that regulators should choose, others that CCPs themselves should: if they can clear it, then it must be cleared. Different CCPs may have different motives. Independent clearing houses may overreach themselves in the hope of scooping up more business. CCPs owned by dealer banks might be more reluctant to clear because their owners might find it more profitable to keep trades purely two-way and charge bespoke prices.

CCPs are lauded for their safety and efficiency. When Lehman Brothers defaulted, LCH.Clearnet, the largest clearer of interest-rate swaps, processed its $9 trillion of OTC interest-rate derivatives seamlessly. Even so, regulators may be creating another set of institutions that are too important to fail. CCPs are supposed to have enough money in hand to withstand the default of one member under "extreme but plausible" conditions—whatever that means. As Ben Bernanke, the Fed's chairman, has noted, CCPs' margin and collateral will never be enough to protect them from a financial earthquake. Taxpayers will have to back them.

Exchange of views

Reforms will accelerate a shift to CCP clearing that was already under way, but proposals to push standardised and cleared derivatives onto exchanges are new, and more contentious. Critics believe large dealers "have a strong incentive to steer clients towards complex OTC rather than exchange-traded derivatives, because the margins are so much greater," says Frank Partnoy, a professor of law and finance at the University of San Diego.

Indeed, commercial banks in America have pocketed $115 billion from cash and derivatives trading in the past ten years, according to the Office of the Comptroller of the Currency, a regulator. "Banks lump their trading revenue together but the significant majority of it comes from derivatives," says Kevin McPartland of TABB Group, a research firm. The market is concentrated, too. In America the leading five dealer banks account for about 95% of all banks' derivative contracts by value. This year trading has been especially lucrative. In the first six months of 2009 American banks earned $15 billion (see chart 3). Market insiders at an inter-dealer broker believe that derivative revenues at the biggest



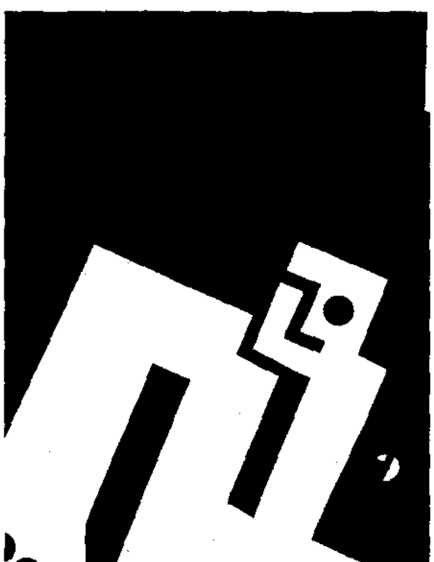
European banks are at least as large.

Robert Pickel, chief executive of the International Swaps and Derivatives Association, a trade group, dismisses accusations of profiteering. He says that users can always phone different dealers to get the best price. And dealer banks are rewarded for risks they assume.

Even so, exchanges would eat into banks' trading profitability by making prices more widely available to buyers of OTC derivatives. But getting OTC derivative markets to use trading platforms is harder than getting them to clear: anything traded on an exchange can be cleared, but the converse is not true.

A simple OTC contract with an obscure maturity date is easy to value and margin. But it would not elicit enough interest from buyers or sellers to justify listing on an exchange. And OTC derivative trades are usually big. On an exchange, a single order could move the market price, creating uncertainty for traders. Mr McPartland likens this to buying a book on Amazon instead of eBay: you often pay more at Amazon, but at least you know the price in advance.

Regulators will permit use of a "swap execution facility" in place of an exchange.



But that term remains undefined. It could mean simply allowing broking over the telephone to continue. Or it could mean an electronic trading system provided by a third party. ICAP, the biggest inter-dealer broker, has two such platforms ready to go.

Watchdogs are also expected to establish data repositories, which will give them unfettered access to dealers' trades. BME, the Spanish stock exchange, launched a new one this month. These should alleviate uncertainty about inter-bank exposures. But Darrell Duffie, a finance professor at Stanford University, worries the reforms will not go far enough. "Any derivatives that are cleared should have the prices made public, regardless of whether they are put through an exchange," he says.

Non-financial firms that use derivatives are keen to escape the new rules. They have no wish to be forced into joining a clearing house and thus into more demanding margin calls. Nor do they like the idea of capital charges. More than 170 of these "end users" wrote to Congress last month arguing that they needed derivatives but would not be able to afford them under the new rules. So far the proposals leave them out. But Mr Duffie asks: "What sort of firm is General Electric?" (it has a big financial division). Regulators fear that hedge funds, which are not strictly financial institutions, will wriggle out, too.

Some argue that those who use derivatives should face the economic cost whatever their legal status. Easier standards for end-users could encourage them to trade even more. Mr Partnoy thinks they are already predisposed to trade too much: "Making $10m profit here and there irresistibly snowballs into a bigger trading operation." Their risk-management, he adds, is not as savvy. Josh Rosner, managing director of Graham Fisher, a financial-research firm, says banks will game the rules: "Dealers like Goldman Sachs could reach agreements with exempted firms like Cargill [a food trader] and funnel their derivative trades through them."

Some companies are acting already. Paul Chrispin of Principal Search, a recruitment firm, reckons that physical trading firms like Noble and Vitol have been on a recruitment drive among banks' derivative traders. "Traders are worried about their future compensation at banks; and the freer regulatory environment at non-financials makes them an attractive place to work right now," he observes.

The ingenuity of derivatives traders in adapting to both market forces and regulations may well send supervisors back to the drawing board in a decade or so. For now, a higher capital charge for OTC contracts is a sensible step. Doing away with derivatives altogether is neither wise nor likely. As Mr Scholes says: "Cars cause accidents but we don't ban them." But the state does insist on seat belts. ■

Also in this section

The world economy

Dangerous froth

WASHINGTON, DC

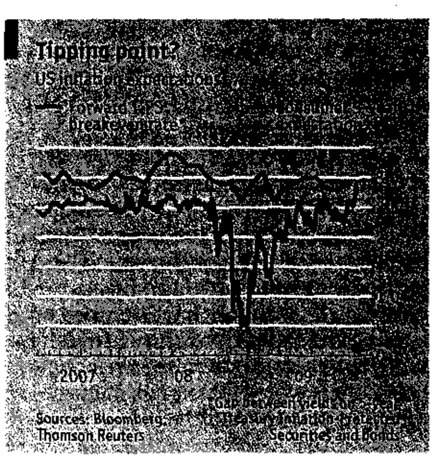
Asset prices could push central bankers off course long before any bubbles burst

THE post-crisis challenge for central bankers has long seemed easy to describe. They must steer between the shoals of short-term deflation and the longer-term risk of accelerating consumer prices. But recently a new concern has cropped up: that loose monetary conditions are creating dangerous bubbles in all manner of assets, from oil prices to Asian apartments, that could capsize the global recovery.

Asset prices have certainly risen impressively. The S&P 500 index is up by 62% from its low on March 9th; the MSCI index of emerging-economy shares has climbed by 114% from its nadir of a year ago; the price of oil is 155% higher than it was in December 2008. Gold prices set a new record of over $1,120 an ounce on November 12th (see page 80). Chinese house prices rose at their fastest pace in 14 months in October.

However, these rebounds have followed even more dramatic slumps, so asset-price levels are less eye-popping. Gold apart, commodities are still well below the peaks of mid-2008. The earnings multiple for Shanghai's A-share index is less than half the level it reached during the 2007 bubble. American shares may be richly valued relative to earnings, but they are less unhinged than in earlier booms. According to Smithers & Co, a research firm, the price-earnings ratio for America's S&P 500 on a cyclically adjusted basis is about 40% above its long-term average, compared with over 100% in the late 1990s.

There are other reasons for calm. Earlier this year investors were in panic mode. Much of the rebound since then reflects a return to more normal risk appetites. Nor is today's asset boom fuelling the kind of leverage that made the bust so awful. Bank lending is contracting in America and weak elsewhere in the rich world. In Asia, property-related borrowing is heavily curtailed compared with America's pre-crisis boom. And from Singapore to Seoul, the authorities are demanding higher down-payments from borrowers and restricting lending to developers (see page 78).



Nonetheless, it would be a mistake to be too sanguine. Another violent drop in share prices could have disproportionate effects on confidence and hence demand. Equally important, frothy asset prices could cause damage long before any bubbles burst, by increasing the risk that central bankers make mistakes.

This risk is most obvious in those countries—mostly emerging markets—where domestic conditions call for tighter monetary policy. China is Exhibit A. With a vigorous domestic recovery under way, China ought to tighten soon, before asset prices bubble out of control. But China is loth to allow the yuan to appreciate rapidly. And it will not be pressured by high consumer-price inflation, as it was in 2008. Thanks largely to soaring pork prices, China's annual inflation rate reached almost 9% early that year. Today it is negative and few expect consumer prices to rise by much more than 3-4% in 2010.

Asset-price rises are also a problem for emerging economies with flexible exchange rates. Many have seen their currencies soar as foreign money pours in. Raising interest rates to tighten domestic monetary conditions can attract yet more foreign money. Increasingly countries are turning to controls on capital inflows. Brazil has already introduced a 2% tax on foreign portfolio investments to stem the rise in the real. On November 10th Taiwan banned foreign investors from putting money into Taiwanese fixed-term deposits. More such measures are likely, increasing the chance of distortions.

In weak, rich economies the danger is ▸▸

not too little too late, but too much too soon. Jumps in asset prices risk causing premature inflation jitters. Oil prices, especially, pose a danger. In recent months year-on-year headline inflation rates in most of the world's big economies have been negative, largely because oil prices have been far below the heights of mid-2008. That is about to change dramatically, as the slumping oil prices of late 2008 and early 2009 affect the comparisons.

In America headline consumer prices fell by 1.3% in the year to September. By December they could be up by 3%. Even if oil prices stay around $80 a barrel, these "base effects" could keep America's headline inflation above 2% for much of the first half of 2010. Many expect commodity prices to continue rising. Analysts at Goldman Sachs expect a barrel to cost $95 by the end of next year. Long-dated futures contracts are now flirting with the $100 mark.

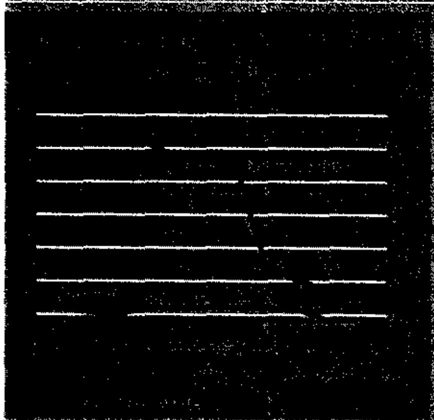
An energy-driven headline inflation rate of 3% hardly spells disaster. Core inflation, which strips out jumpy food and fuel prices, is low, at 1.5%, and falling, thanks to the huge amount of slack in the economy. With a jobless rate of 10.2% and oodles of idle capacity, America still faces a bigger threat from deflation than from inflation.

The risk is that higher headline inflation is misinterpreted as a sign that policy is too loose. Judged by the "breakeven" rate between inflation-protected and other Treasury bonds, financial markets' estimates of long-term inflation have jumped of late, although consumers' expectations have remained stable (see chart on the previous page). Worries about the size of America's budget deficit and fears about the potential politicisation of the Federal Reserve are rising. (A proposal released this week by the Senate Banking Committee which strips the Fed of supervisory powers and introduces political appointments to the regional reserve-bank boards hardly helps). There is a danger that higher headline inflation will be misread, even as rising energy costs sap demand.

Vince Reinhart of the American Enterprise Institute worries about a replay of the summers of 2007 and 2008. On both occasions a weaker dollar, rising oil prices and a "decoupled" world economy made America's central bank more hawkish. Although it did not raise rates, "inflation jitters" were pervasive. The European Central Bank actually raised rates in July 2008.

History will not repeat itself exactly. But bubbly asset prices do risk overreaction from rich-world central bankers. That may temper worries in the emerging world but at the risk of pushing the global economy back into recession. Central bankers ignore asset prices at their peril. But dealing with them is not easy either. ■

The not-so-little guy



South Korea's recovery

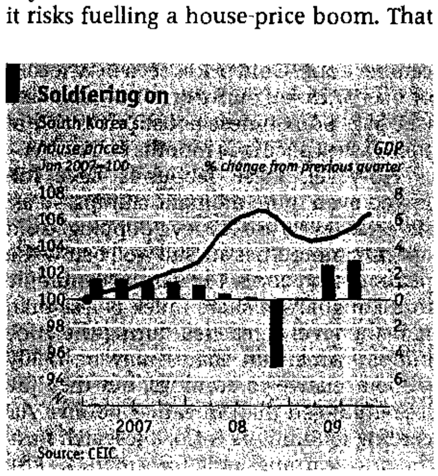
Leaning experience

SEOUL

Ways to stop boom turning to bust

"NEVER waste a good crisis," says Lee Myung-bak, South Korea's president. A good crisis, indeed. After plunging by 5.1% in the fourth quarter of 2008, the economy was one of the first in the OECD to start growing again, three months later. It is now bigger than it was before Lehman Brothers collapsed. Technically, it did not even suffer a recession. In Seoul the housing market barely paused (see chart).

But such buoyancy puts the financial authorities in a bit of a bind. On the one hand their loose monetary and fiscal policies (along with inventory restocking and a powerful shove from China) have helped produce what appears to be a quick recovery. On the other hand the low cost of credit risks fuelling a house-price boom. That ▸▸



[redacted]

means South Korea is among the first to grapple with one of the new orthodoxies in the post-crisis world: the need to lean against excessive asset-price movements.

The problem originates in Seoul where house prices, especially in the upmarket Kangnam district south of the river, are near or at record highs. The capital's property numbers skew national housing statistics. As a result there has been pressure on the central bank to raise interest rates, which are at zero in real terms.

But monetary policy is a blunt instrument. If rates were raised high enough to restrain mortgage lending, they could also jeopardise the broader economy, especially since household and corporate debt together add up to as much as 200% of GDP. Until there are signs that the private sector, rather than public largesse, is driving economic growth, the Bank of Korea, which kept rates unchanged for a ninth consecutive month on November 12th, will be in no great hurry to change its stance.

Lee Seong-tae, the governor of the Bank of Korea, believes that the central bank, like others elsewhere, will have to be increasingly alert to the risk of speculative bubbles. "We must exercise greater vigilance over asset-price movements than we did in the past," he said at a recent conference hosted by *The Economist*. But he added: "I don't think the central bank can accomplish price stability by itself."

An alternative is to "micromanage" the housing market by using unconventional means instead of monetary policy. In September the government announced it was limiting the percentage of a borrower's annual income that could be spent on mortgage payments to 50% in Seoul and 60% in two other areas with rising house prices. It has also put curbs on loan-to-value ratios.

Randall Jones, an economist at the OECD, does not believe house prices in South Korea are excessively frothy. Relative to income, they have risen by 5% since 2000, compared with jumps of more than 25% in some other OECD countries. But he also believes the financial authorities may be applying the wrong remedies to the housing market. The problem of soaring prices stems from a lack of new housing and strong incentives to live in the catchment areas of the best schools. Sporadic interventions to limit house-price speculation may even be counterproductive because they discourage people from building more homes. Supply, not demand, may be the real issue. ■

American stockmarkets

High-speed slide

NEW YORK

What is good for cutting-edge traders may be bad for the market as a whole

AMERICA may have been the epicentre of the global financial earthquake but it still boasts the world's deepest and most liquid capital markets, unparalleled when it comes to nurturing young companies. But for how much longer? This week, as bulls cheered the Dow Jones Industrial Average touching a 13-month high, they were forced to digest a sobering report from Grant Thornton, an accounting firm, on the structure of America's stockmarkets.

The report's authors say that America is plagued by a "Great Depression" in the number of listed firms that stretches back over a decade (see chart). For all the talk of a revival in initial public offerings (IPOs), domestic markets are on track to add a mere 50 or so new companies this year, one-seventh of the level needed to offset the average annual loss of listed companies in recent years.

The slide in listings began in the mid-1990s, at around the time that America saw an array of regulatory changes designed to advance high-speed, low-cost trading, such as the introduction of online brokerages and new order-handling rules. An accidental victim of this technological revolution, the report says, was the ecosystem that helped bring small firms to market and then nourished them once there. "It's a bargain-basement market today," says David Weild, a co-author of the report. "You get what you pay for, and that's nothing but trade execution."

The "high-frequency" traders who have come to dominate stockmarkets with their computer-driven strategies pay less attention to small firms, preferring to jump in and out of larger, more liquid shares. Institutional investors, wary of being stuck in an illiquid part of the market, are in- ▸▸

[redacted]

Economics focus | Secret sauce

China's rapid growth is due not just to heavy investment, but also to the world's fastest productivity gains

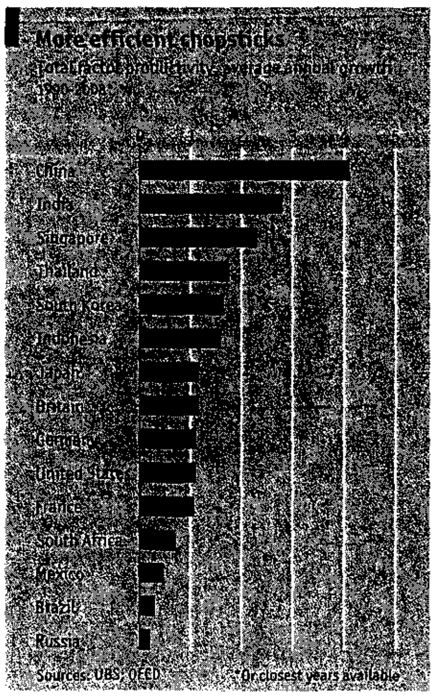
PRODUCTIVITY growth is perhaps the single most important gauge of an economy's health. Nothing matters more for long-term living standards than improvements in the efficiency with which an economy combines capital and labour. Unfortunately, productivity growth is itself often inefficiently measured. Most analysts focus on labour productivity, which is usually calculated by dividing total output by the number of workers, or the number of hours worked. According to new figures published on November 5th, America's output per hour worked has increased by 4.3% over the past year, thanks to big job cuts. Even more impressive is China, where labour productivity has risen by 7-8%.

The snag is that labour productivity is an incomplete gauge of efficiency. Firms can boost output per man-hour by investing more and equipping workers with better machinery. But once the extra capital spending is taken into account there may be little or no gain in overall economic efficiency. Part of the jump in America's labour productivity during the "new economy" era of the late 1990s reflected a rise in investment as a share of GDP. The huge increase in China's labour productivity in recent years is partly due to heavy investment rather than true efficiency gains.

A better gauge of an economy's use of resources is "total factor productivity" (TFP), which tries to assess the efficiency with which both capital and labour are used. Once a country's labour force stops growing and an increasing capital stock causes the return on new investment to decline, TFP becomes the main source of future economic growth. Unfortunately TFP is much harder to measure than labour productivity. It is calculated as the percentage increase in output that is not accounted for by changes in the volume of inputs of capital and labour. So if the capital stock and the workforce both rise by 2% and output rises by 3%, TFP goes up by 1%. Measuring hours worked is fairly easy, but different ways of valuing a country's capital stock can produce different results.

The OECD publishes figures for its rich-country members. These show that since 1990, average TFP growth has been remarkably similar in America, Japan, Germany, Britain and France, at around 1% a year. A recent report by Andrew Cates, an economist at UBS, attempts to estimate TFP growth in emerging economies over the past two decades (see chart). He calculates that China has had by far the fastest annual rate of TFP growth, at around 4%. Probably no other country in history has enjoyed such rapid efficiency gains. India and other Asian emerging economies have also enjoyed faster productivity growth than other developing or developed regions. In contrast, productivity in Brazil and Russia has risen more slowly than in rich economies.

These figures undermine a common claim—that China's rapid growth has been based solely on overinvestment. Sceptics like to compare China with the Soviet Union, where heavy investment also produced rapid rates of growth for many years before it collapsed. But the big difference is that TFP in the Soviet Union actually fell by an annual average of 1% over 30 years to 1988. In contrast China's productivity has been lifted by a massive expansion of private enterprise, and a shift of labour out of agricultural work and into more productive jobs in industry. China's average return on physical capital is now well above the global average, according to Goldman Sachs. A decade ago it was less than half the world average.



Why have the Asian economies led the pack? The most important determinants of longer-term productivity growth are the rate of adoption of existing and new technologies, the pace of domestic scientific innovation and changes in the organisation of production. These, in turn, depend on factors such as the openness of an economy to foreign direct investment and trade, education and the flexibility of labour markets.

Using a composite index of technology penetration and innovation (including, for instance, computers and mobile phones per head), Mr Cates finds a strong link between the rate of increase in an economy's technological progress and its productivity growth. China's level of technology is still well behind that in America, but it has seen by far the fastest rate of improvement over the past decade. This is not just because China started from such a low base but also because it is more open to foreign investment than many other emerging economies, including Japan and South Korea when they were at similar stages of development. China's TFP growth is almost twice as fast as that of Japan and South Korea during their periods of peak economic growth.

An emerging advantage

UBS's analysis suggests that the financial health of firms and governments also matters for productivity growth. Although TFP measures the extra gain in economic efficiency after taking account of the direct impact of a larger capital stock, weak balance-sheets constrain the availability of capital for new technology and innovation. The financial crisis may therefore reduce TFP growth in many rich countries. Some analysts also worry that future productivity growth in emerging economies will be curbed by slower growth in world trade and capital flows. But Mr Cates argues that healthier domestic balance-sheets in most emerging economies, along with continued rapid adoption of old and new technologies, should support robust productivity gains. He thinks that China, India, Indonesia and Brazil look particularly well placed. China's surge in infrastructure spending will also help.

That said, even if China's productivity growth remains faster than that of the developed world, it is likely to slow unless the government pushes ahead with bolder reforms. China's growth is still too capital-intensive. Opening up the service sector to private firms and making it easier for workers to shift from rural to urban areas would result in a better allocation of labour and capital. That would help sustain rapid growth but would also make it more job-intensive. The resulting fall in labour-productivity growth might cause alarm among some analysts, but TFP would remain strong. ■

How to feed the world

Business as usual will not do it

IN 1974 Henry Kissinger, then America's secretary of state, told the first world food conference in Rome that no child would go to bed hungry within ten years. Just over 35 years later, in the week of another United Nations food summit in Rome, 1 billion people will go to bed hungry.

This failure, already dreadful, may soon get worse. None of the underlying agricultural problems which produced a spike in food prices in 2007-08 and increased the number of hungry people has gone away. Between now and 2050 the world's population will rise by a third, but demand for agricultural goods will rise by 70% and demand for meat will double. These increases are in a sense good news in that they are a result of rising wealth in poor and middle-income countries. But they will have to happen without farmers clearing large amounts of new land (there is some scope for expansion, but not much) or using up lots more water (in parts of the world, water supplies are stretched to their limit or beyond). Moreover, they will take place while farmers also wrestle with the consequences of climate change, which, on balance, will do more harm than good to farmland round the world.

It may be too late to avoid another bout of price rises. Despite a global recession and the largest grain harvest on record in 2008, food prices are heading up again. Still, countries have a brief window of opportunity in which to set long-term policy goals without being distracted by panic measures. They need to do two things: invest in the productive capacity of agriculture and improve the operation of food markets.

Governments have done one but not the other. Over the past year investment has risen faster than anyone expected. But distrust of markets and a reaction against farm trade are growing. Unless governments restrain those impulses, they will undermine the gains from rising investment.

The quarter-century slumber

For most of the past 25 years, investment in agriculture has declined relentlessly. In 2005 most developing countries were investing only around 5% of public revenues in farming. The share of Western aid going to agriculture fell by around three-quarters between 1980 and 2006. This disinvestment laid waste to productivity. During the Green Revolution of the 1960s, staple-crop yields were rising by 3-6% a year. Now they are rising by only 1-2% a year; in poor countries, yields are flat.

Fortunately, the food-price spike of 2007-08 shocked governments out of their quarter-century of neglect. The World Bank and many rich countries have doubled the money they put into poor countries' farming. In the poor countries themselves, agriculture has gone from being a sideshow for the government—something the minister of agriculture does—into its main event, which everyone needs to worry about. This is as it should be: farming is far and away the single most important economic activity in most poor places.

Some of the new splurge of public money is going on safety-net programmes for poor farmers, which are justified on anti-poverty grounds: three-quarters of the world's poorest live in rural areas. But the money will pay dividends in the long run only if it improves farmers' access to market. Lack of reliable markets is the biggest barrier to rural development, since without them farmers have little incentive to grow more. So the increase in rural road-building is welcome, as are measures to improve the operations of local markets by (for instance) spreading price information and building grain stores. There is also a case for temporarily subsidising better seeds and fertilisers in places where local markets are failing to provide them: this is an example of correcting market failure.

Boosting world food production without gobbling up land and water will also require technology to play a larger role in the next 40 years than it has in the past 40, when people have been more or less living off the gains of the Green Revolution. Technology means a lot of things: drip irrigation, no-till farming, more efficient ways to use fertilisers and kill pests. But one way of raising yields stands out: developing genetically modified (GM) crops that, for example, use less water. Here, too, public bodies can overcome resistance. GM crops may be more acceptable if they come from government institutes than big companies or if the seeds are given away, rather than sold (which may be why Monsanto is doing that; see pages 71-73).

I'm not all right, Jack

There is, however, a danger inherent in all this government activity: the temptation of self-reliance. The food-price rise of 2007-08 made all countries worry about "food security"—quite rightly. But over the past year "food security" (ensuring everyone has enough to eat) has shaded into "food self-sufficiency" (growing it all yourself). Self-sufficiency has become a common policy goal in many countries (see pages 61-63).

In itself, self-sufficiency is not bad. If poor countries have a comparative advantage in producing their own food, they should do so (and that will often be the case). The problem is that the new rhetoric of self-sufficiency coincides with a growing distrust of markets and trade. Grain importers no longer trust world markets to supply their needs. "Land grabbers" are snapping up land abroad to use for food production. Everywhere, governments are more involved in farming through input subsidies. In these conditions self-sufficiency could easily sprout protective walls.

That would be in nobody's interest. As Europeans have demonstrated over decades, pursuing self-sufficiency above all else is extremely wasteful. Self-sufficiency would also lock in patterns of agricultural production just when climate change is affecting different parts of the world differently, making trade between them all the more important.

The food-price trauma of 2007-08 is persuading some countries to say that they need to divert part of their wealth to subsidise food so they can be self-sufficient and avoid future crises. But the demands of feeding 9 billion people in 2050 tell a different story: farming needs to be as efficient as possible. That requires markets and trade. Investing in agriculture is a boon; rejecting agricultural markets would be a disaster. ■

Banyan | Land of Eastern promise

India's membership of Asia remains primarily cartographic

AN EASY but instructive way to bait an Indian economist is to credit the Chinese economy with coming to Asia's rescue and arguably the world's. It is, claims the economist, an example of anti-India bias. Why does India not get equal credit for robust growth? In all the frothy coverage about Asia's amazing rebound, including in *The Economist*, where is India? "You'd think", the economist complains, "that India isn't even part of Asia."

To what degree India's economy is part of a vibrant Asian whole has long been a preoccupation among Indian policymakers. Now the global slowdown has given the debate a keener edge, for it has disproportionately hit the commercial markets in America and Europe to which India traditionally looks. "Look East", long an avowed tenet of government policy, is in vogue.

There is something to the economist's complaints. For all the credit that it gets for its recovery, China's near double-digit show this year is mainly a command-economy extravaganza involving massive state-directed spending. When that show is over, the skew in China's economy—an undervalued currency, a mercantilist bias in favour of manufactured exports and an obsession with accumulating foreign reserves—remains less the solution to global imbalances than one of the fundamental causes.

By contrast, though India's annualised growth rate of around 6% this year is below China's heady levels, it is impressive against a backdrop of global turmoil. What is more, government stimulus plays only a small part in the growth. Levels of capital and infrastructure investment compare favourably with China's. And, much more than in China, the hot story in India is domestic demand. India is no mercantilist adding to global imbalances. It imports more than it exports, creating much needed global demand. India's long-run growth will overtake even China's.

All well and good. But it does not explain how much India is indeed part of Asia. Flows of foreign direct investment (FDI) suggest that the bond is ever tighter. India is now the second-most-popular global destination for FDI, behind only China, and much of this is Asian investment. Total inward investment was $23 billion in 2007 (the latest available figure), up over two-fifths on a year earlier. The target of $30 billion for 2008-09 is unlikely to be met, but inflows into India still defy the global slump.

Moreover, India is playing late catch-up with China, with FDI rising from just a few percent of China's figure in 2000 to about a quarter today. Much of the increase has come from East Asia. Measured by flows, India is overtaking China as Japan's biggest destination for foreign investment and, according to a survey by the Japan Bank for International Co-operation, will be the most favoured destination for long-term Japanese investments over the next decade. As for South Korea, consumer-electronics firms are driving a push into India. Cracking the rumbustious market—LG Electronics advertises in a dozen Indian languages—is the kind of offensive that Korea's shock-troop salesmen relish.

Three years ago the then Japanese government defined a wide "arc of freedom and prosperity", one end anchored in Japan, that took in India on its path. The new government of the Democratic Party of Japan has dropped the arc in name, but it survives in practice. India and Japan are strengthening economic and security ties. Japan sends 30% of its official aid to India and has promised over $4 billion for a "Delhi-Mumbai industrial corridor". In South Korea, a finance-ministry bigwig says his urgent priority is to persuade young ministry high-flyers, who invariably apply for an American posting, to go to India instead.

And yet. India's economic ties with East and South-East Asia fall short. For this columnist flying the free, prosperous arc from Tokyo to Delhi means an 18-hour schlepp via Hong Kong and Bangkok. Direct flights between Delhi and Beijing began only three years ago, and run to only four a week, with the odd supplement provided by Ethiopian Airlines.

And although India is opening some sensitive industries, such as telecoms and retail, to foreign investors, ownership limits remain. The obstacles work both ways. India's information-technology giants, stars of international outsourcing, bang their heads in Japan and South Korea, where conglomerates' ingrained habits of managing IT in-house persist. In trade (both goods and services), a welter of impediments persist. For instance, India's drug companies are shut out of Japan, the world's second-biggest market for pharmaceuticals. Auditing, advertising, textiles, medicines, you name it: one or other country has objections. Free-trade negotiations between India and Japan have dragged on for years, with no deal in sight.

The missing link

Most glaring of all, India is largely absent from those supply chains in East and South-East Asia that have come to exemplify globalisation itself. Partly that is because by the time India started to open up in the 1990s they were already established. Partly it is because Indian elites have long looked to America and then Europe for their education and business opportunities. But partly it is because of abiding suspicions of China, which happens to lie at the heart of the networks.

Some suspicions are economic. At home, small Indian businesses have lobbied to block the negotiation of a China-India free-trade agreement for fear of Chinese competition. But they are mainly geopolitical. Indeed, China's preponderance in East Asia seems to provide the rationale for India's "Look East" policy, and its encouragement by Japan, South Korea and Taiwan, which also seeks closer ties with India. India is welcomed in the region as China's counterweight. On security grounds, the impetus may be justified. On economic grounds, unless surviving trade impediments are broken down, it makes for pretty lousy policy. ■

Economist.com/blogs/banyan

Also in this section

Green.view, our online column on the environment, appears on Economist.com on Mondays. The columns can be viewed at Economist.com/greenview

Feeding the world

If words were food, nobody would go hungry

ROME

Investment in agriculture is soaring. So, worryingly, is distrust of markets and trade

"THE world's attention is back on your cause." That was Bill Gates talking to agricultural scientists gathered recently to honour the late Norman Borlaug, father of the Green Revolution. The tycoon-turned-philanthropist was right. This week, the world—in the guise of 60-odd heads of state including the pope—held the first United Nations food summit since 2002. As the world's attention turns from the receding financial crisis, it is switching to one emerging in agriculture.

The UN conference on food security took place at a point of relative calm between two storms. The first occurred in 2007-08, when world food prices experienced their sharpest rise for 30 years. Food riots swept through three dozen countries and two governments (Haiti's and Madagascar's) were overthrown by the events that the price rises set in train.

The next storm is likely within a few years and everyone fears its arrival. The price spike of 2007-08 was the result of structural imbalances in the world food chain, not just temporary fluctuations like bad weather or government mistakes. These imbalances have not gone away: food demand is still rising because of changing appetites and rising incomes in emerging markets; biofuels are still competing with food crops for available land; yield growth in cereals is declining.

In 2008-09 food problems were masked for a while by the financial crisis. But as Jacques Diouf, head of the UN's Food and Agriculture Organisation (FAO), said this week, "when the recovery picks up, we will be back to square one." Jeffrey Currie of Goldman Sachs argues that while most recession-hit industries in the rich world are operating at 60-70% of capacity, agriculture is at full capacity, in the sense that last year's cereals crop was the largest on record and there is little fallow land ready to be taken under the plough. If there were another supply or demand shock, the farm-trade system would not cushion the blow.

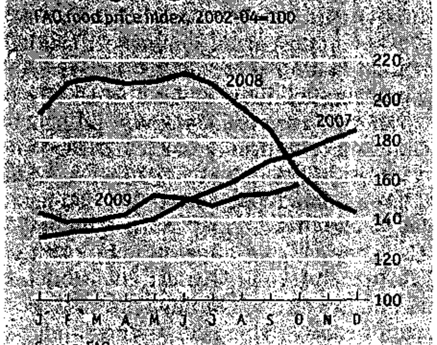
It may not be many years away. In the first ten months of this year, food prices rose by 9.8%, prompting fears of a resumption of the surge that began in 2007, the first of the two years of crisis (see chart). The "breakfast commodities" (tea, cocoa, sugar, important sources of calories in some parts of the world) are trading at their highest levels for 30 years. Worse, the price respite, while it lasted, did nothing for the poorest and most vulnerable. According to the FAO, the number of malnourished people in the world rose to over 1 billion this year, up from 915m in 2008 (see chart on next page). Economists at the World Bank reckon that the number living on less than $1.25 a day will rise by 89m between 2008 and 2010 and those on under $2 a day will rise by 120m. A quarter of a century after a famine in Ethiopia which dramatised failings in the food system, famine is again stalking the Horn of Africa. Has anything been done to prepare for future food shocks?

Certainly, say most governments. Money is starting to pour into agriculture after 30 years of neglect. There has been a spasm of institutional reform. And public and private sectors are doing more to help farmers than ever.

At their meeting in L'Aquila in July, the Group of Eight (G8) large rich economies promised to increase spending on agricultural development by $20 billion over the next three years. Not much of this was new money (probably $3 billion-5 billion) and it is not clear how much, if any, has been delivered. The amount also falls far short of the $44 billion that the FAO guesses will be needed each year to end malnutrition (and ▸▸

Creeping up again

FAO food price index, 2002-04=100



Source: FAO

even shorter, aid agencies reflect, of the $14 trillion poured by rich countries into their banks). Still, the amount is not trivial. It would finance for three years the annual $7 billion that the International Food Policy Research Institute (IFPRI), a think tank in Washington, DC, estimates will be the bill for developing countries to protect agriculture from the impact of climate change. And it excludes the far greater sums developing countries themselves are promising to farming.

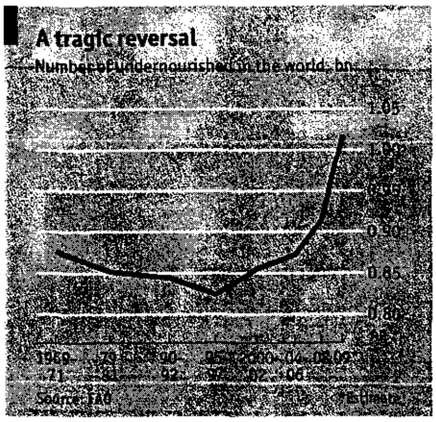
Agriculture and food security have become "the core of the international agenda", as the G8 called it. In 2009, the World Bank increased its spending on agriculture by 50%, to $6 billion. The Islamic Development Bank is creating an agriculture department for the first time.

Barack Obama asked Congress to double to just over $1 billion America's aid for agricultural development in 2010. And in a sign that food productivity means more than warm words and cash, he nominated a pundit, not a politician, to head USAID, the assistance agency: Rajiv Shah, the chief scientist for the Department of Agriculture. In the West, there is a new consensus on the need to invest more in agriculture in emerging markets.

Jeffrey Sachs, an economist at America's Columbia University, has argued that the next step should be to create a new international agency to co-ordinate all the money and perhaps have a big budget of its own. He wants something similar to the global fund to fight HIV/AIDS, a public-private partnership. Earlier food shortages, in the 1970s, had also produced institutional shake-ups: the International Fund for Agricultural Development (IFAD) and the Consultative Group for International Agricultural Research (CGIAR), influential groups in the field, were both set up then.

But the latest crisis has not spawned any institutional children, mainly because the UN food agencies—FAO, IFAD and the World Food Programme—spent too much time bickering. Instead, institution-building took the form of tinkering. The idea for what was grandly labelled a global partnership on food security began with the French president, Nicolas Sarkozy, in the spring of 2008 and morphed into a UN committee and a "high-level task force" attached to the secretary-general's office. So far, this modest arrangement seems to be working rather well, at least in terms of mobilising attention and resources.

The most important activity, though, is taking place at the national level. Here, the price rises of 2007-08 have unleashed an unprecedented pack of policies. Practically every developing country, however cash-strapped, has done something (often a lot) to help farmers. African governments are finally starting to fulfil a promise they made in 2003 to spend 10% of their budgets on agriculture. The most popular measures have been to build rural roads, subsidise inputs such as seeds and fertilisers, give special help to the poorest smallholders as a kind of safety net, and to intervene in the operation of markets, sometimes to improve and sometimes to control them.



The Philippines set up a seed bank to improve the quality of seeds and provide a reserve against occasions when crops are wrecked by typhoons (the country is prone to such disasters). Lesotho and Uganda created "seed fairs" in the hope of increasing the varieties on offer to give farmers. Tanzania and Mali tried to achieve the same end by subsidising the grain and fertiliser merchants directly. Nepal and Jamaica offered cheap kits (pumps, drip feeds) to persuade smallholders to irrigate their fields. Malawi kept going its much-studied fertiliser subsidy, which practically gives the stuff away to the poorest farmers. The jury is still out on what will happen if and when the country can no longer afford the programme, which is eating up 4.2% of GDP. But there is no doubting the impact so far: the programme has turned Malawi into a breadbasket: in 2005, the country imported over 40% of its food; this year, it will export more than half its output, including to famine-stricken Kenya, having trebled the maize harvest in four years.


Food insecurity in the Philippines

Brazil also subsidised inputs, launching a programme that provided credit for 14,000 tractors in its first year. But its bigger intervention was to expand a safety net which allows family farmers to sell $800 worth of food to the government each year; the government uses part of the food for reserves to help stabilise prices and another portion for school meals which are part of the country's much-admired conditional-cash transfer scheme, Bolsa Familia.

Many countries are using help to farmers as an anti-poverty measure. India, for example, last year extended to every rural district its National Rural Employment Guarantee Act, which guarantees 100 days of minimum-wage employment on public works to every rural household that asks for it. The act, one of the biggest job-creating schemes in the world, is widely credited with maintaining rural demand in the face of one of the worst monsoons for years. India also introduced a one-off agricultural-debt waiver programme for about 40m farmers.

At the height of the food-price spike in 2008, many of the biggest food producers banned the export of crops (they sought to cushion the domestic impact of rising world prices). Most of these restrictions have been lifted and replaced by a variety of price and marketing policies. Many of them are sensible. Uganda, for example, reckons farmers got 5-15% more for their crops after publishing price and market information more widely. Kenya improved peoples' nutrition by removing restrictions on the sale of unpasteurised milk (milk is one of the most important foodstuffs in east Africa). There is also a fashion for creating grain reserves to smooth out local price fluctuations by building silos in villages: Burkina Faso, Burundi and Gambia are doing this.

It all sounds admirable. And it is matched by an almost equally frenetic pace of change among commercial food companies. Some have started to invest directly—often for the first time—in farming in poor countries, providing farmers with new varieties of seeds or drought- and disease-resistant plants (see pages 71-73 for a case study of Monsanto). Agricultural business centres—one-stop shops where farmers can go to buy seeds and fertilisers, rent farm equipment, and get crop insurance—are springing up everywhere.

This little piggy didn't go to market

Yet there are worrying signs that all is not well. For alongside the increases in investment and attention is something more insidious: a turn away from trade, markets and efficiency. Depending on how far this goes, the trend could undo much of the benefits of new investment.

The price rises of 2008 were traumatic. When Thailand and Vietnam, the world's two largest rice exporters, banned exports, the Philippines, the world's largest importer, concluded that the international grain trade could no longer be trusted to supply its needs. Fearing what might happen as a result of India's poor harvest this year, the Philippines in the past two weeks has concluded contracts to buy 1.5m tonnes of rice—equivalent to 5% of the total annual trade in the grain. This is panic buying driven by mistrust. In turn, India is negotiating directly with Thailand and Vietnam for rice, which would further reduce the tradable supply of an already thinly traded commodity.

The large "land grabs" in Africa and Asia are also signs of distrust in world markets. Food importers which can afford it—like Saudi Arabia, Kuwait, China, South Korea—have opted to grow food on land they own or control abroad rather than import it through international trade. "Land grabbers" (mostly state companies or governments) have concluded contracts to buy or lease roughly 20m hectares (50m acres) of the best farmland in poor countries.

Trust in world grain markets seems weak among industrial countries, too. Western countries share the blame for the failure to complete the Doha round of trade talks. They have done little to reduce subsidies to biofuels, which have taken large quantities of maize out of food markets and put it into petrol tanks. IFPRI and others have urged countries to calm the wildest price fluctuations (and hence provide a measure of reassurance to importers) by setting up a system of international or regional grain reserves or by providing emergency financing to be drawn upon if prices spike. But the summit did nothing to improve the operation of world markets or to cut biofuels subsidies.

And just as distrust of world trade seems to be growing, so confidence in domestic markets seems to be falling. According to a review of national farm policies by the FAO, around two-thirds of developing countries have undertaken some sort of non-market-based measures to support farmers since 2007, including input subsidies and price interventions. The governments of Burkina Faso and Sierra Leone have started to negotiate with wholesalers to control prices indirectly. Other countries, such as Madagascar, have imposed direct price controls. The picture here is mixed: some countries are seeking to improve the operation of their markets. But six of 34 African countries which reported their policy responses to the FAO said they were proposing price controls.

Perhaps the most striking trend is the move from "food security" towards "food self-sufficiency" as a goal of national policy. The first means ensuring everyone has enough to eat; the second, growing it yourself. The Philippines says it hopes to grow 98% of the rice it needs by next year, though whether it can meet this target is unclear. "Indonesia must struggle to reach food self-sufficiency," said President Susilo Bambang Yudhoyono last year, announcing big increases in seed, fertiliser and credit subsidies. Senegal imports 80% of its rice, putting this small African nation in the top ten rice importers. Rocked by food riots in 2008, the government responded with what it called the "Great Offensive for Food and Abundance", and promised to become self-sufficient in staples. Others with the same aim include China, Malaysia, Colombia and Honduras.

This shift towards self-sufficiency coincides with growing scepticism about world trade, examples of price controls and more extensive government involvement. The FAO has even suggested the shift may amount to "a change of paradigm" in farming.

Such a shift could undermine the hopes raised by new investment because farmers would get bogus price signals, efficiency would be compromised and because, says IFAD's head of operation, "it's harder to do good projects where the policy environment is poor." Food policy has never been free. For the past 20 years, agriculture in developing countries has been dominated by a gradual decline in investment and a shift towards a somewhat more liberal policy environment. The first trend is now being reversed, for the better. The worry is that the second trend will be reversed, too—for the worse. ■

Food markets

How to store and sell more stuff

Poor places need more than seeds, fertiliser or even food science

IF FOOD aid is epitomised by a single image, it is that of neat bags of grain stamped with the Stars and Stripes and labelled a "gift from the American people", being unloaded in some benighted place. In a long-established practice, USAID buys food from American producers and then gives it to charities who sell the produce on the markets of indigent countries and in turn use the proceeds to finance their anti-poverty work.

This method has its detractors, who say that sales of American food depress local markets—in theory at least, all sales should be calibrated to avoid that effect. But in a switch which might help to pacify those critics, USAID is now putting more emphasis on helping farmers in recipient countries to harvest, store and above all sell their own food. Many of the changes now being encouraged have no relation to food production as such; they have to do with the ways markets are organised, credit is disbursed and laws are enforced.

So far, three African countries—Senegal, Ghana and Nigeria—have undergone an exercise known as AGCLIR in which USAID takes a hard look at the non-agricultural factors that hold back the successful production and sale of food. These assessments are made at the discretion of local USAID bureaus, but they are being strongly encouraged by the agency's head office in Washington, DC.

Among the early findings: in many places, the supply of inputs is unhealthily monopolised. Also farmers find it hard to raise loans or enter contracts because there is no registry of assets, or proper system of commercial law, which would give confidence to lenders and buyers. So local capital flows into government bonds when it could go into farming, says Russell Brott of Booz Allen Hamilton, a consultancy which advises USAID.

Suspicious types may think AGCLIR is just a way of testing the friendliness of poor countries to American investors, but the scope is wider. Senegal, for example, is friendly enough to foreign investors, agricultural and otherwise. But as an AGCLIR report usefully spells out, it makes life pointlessly hard for its own farmers and food traders: "undue police interference and on-the-road shakedowns" deter the internal transport of food. Such curable woes help explain why a country where 75% of people work in the food business still has to import [illegible]% of its food supply.

A symbol of succour

Also in this section

China's exchange-rate policy

A yuan-sided argument

HONG KONG

Why China resists foreign demands to revalue its currency

PRESIDENT BARACK OBAMA, on his first visit to China this week, urged the government to allow its currency to rise. President Hu Jintao politely chose to ignore him. In recent weeks Jean-Claude Trichet, the president of the European Central Bank, and Dominique Strauss-Kahn, the managing director of the International Monetary Fund, have also called for a stronger yuan. But China will adjust its currency only when it sees fit, not in response to foreign pressure.

China allowed the yuan to rise by 21% against the dollar in the three years to July 2008, but since then it has more or less kept the rate fixed. As a result, the yuan's trade-weighted value has been dragged down this year by the sickly dollar, while many other currencies have soared. Since March the Brazilian real and the South Korean won have gained 42% and 36% respectively against the yuan, seriously eroding those countries' competitiveness.

Speculation about a change in China's currency policy increased in the week before Mr Obama's visit, after the People's Bank of China tweaked the usual wording in its quarterly monetary-policy report. It dropped a phrase about keeping the yuan "basically stable" and added that foreign-exchange policy would take into account "international capital flows and changes in major currencies". But exchange-rate policy is decided by the State Council, not the central bank. And many policymakers, notably in the Ministry of Commerce, do not favour a revaluation right now.

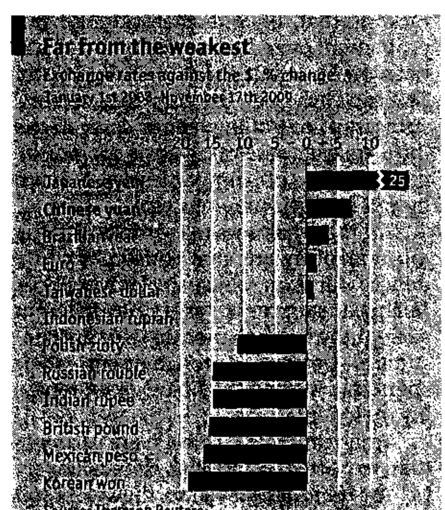
Indeed, Chinese officials have become bolder in standing up to America. "We don't think that it's good for the world economic recovery that you ask others to appreciate while you depreciate your own currency...It's also unfair," said a spokesman for the Ministry of Commerce on November 16th. The previous day Liu Mingkang, China's chief banking regulator, blasted America for its low interest rates and for the falling dollar, which, he suggested, might be encouraging a dollar carry trade and, in turn, global asset-price bubbles. He strangely ignored the fact that China's own overly lax monetary policy, partly the result of its fixed exchange rate, risks fuelling bubbles in its domestic property and equity markets.

Foreigners argue that a stronger yuan would not only help reduce global imbalances, such as America's trade deficit, but would also benefit China. It would help China regain control of its monetary policy. By pegging to the dollar, it is, in effect, importing America's monetary policy, which is too loose for China's fast-growing economy. A stronger yuan would also help rebalance China's economy, making it less dependent on exports, putting future growth on a more sustainable path.

If a stronger exchange rate is in China's own interest, why does it resist? Beijing rejects the accusation that its exchange-rate policy has given it an unfair advantage. It is true that other emerging-market currencies have risen sharply this year, but this ignores the full picture. Last year China held its currency steady against the dollar throughout the global financial crisis, while others tumbled. Since the start of 2008, the yuan has actually risen against every currency except the yen (see chart).

China also argues that it has done a lot to help global rebalancing. Thanks to its monetary and fiscal stimulus, domestic demand has contributed an remarkable 12 percentage points to GDP growth this year, while net exports subtracted almost four percentage points. Its current-account surplus has fallen by almost half, to around 6% of GDP from 11% in 2007. Chinese policymakers accept that the yuan needs to appreciate over the longer term, but say now is the wrong time, because Chinese exports are still falling, by 14% over the past 12 months.

Another reason for hesitation is that the ▸▸

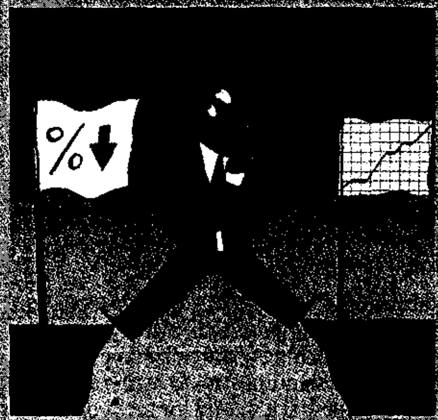


theory that revaluing the yuan will allow Beijing to tighten its monetary policy is too simplistic. China's experience since 2005 shows that a gradual rise encourages investors to bet on further appreciation; hot-money inflows then swell domestic liquidity. A large one-off increase might work, as it would stem expectations of a further rise. But the sort of increase required—perhaps 25%—is politically unacceptable because it would put many exporters out of business overnight.

Some Chinese economists warn that the benefits to America from yuan revaluation are much exaggerated. In particular, a stronger yuan would not significantly reduce America's trade deficit. There is little overlap between American and Chinese production, so American goods could not simply replace Chinese imports. Instead, consumers might end up paying more for imports from either China or other producers, such as Vietnam. This would be like imposing a tax on American consumers.

These arguments help explain why China is dragging its feet. Nevertheless, in the long run, a stronger yuan would benefit China's economy—and the world's—by helping shift growth from investment and exports towards consumption. It would boost consumers' purchasing power and squeeze corporate profits, which have accounted for most of the increase in China's excessive domestic saving in recent years. China will probably allow the yuan to start rising again early next year. This will not be the result of foreign lobbying—indeed, China is more likely to change its policy if foreign policymakers shut up. But by early next year China's exports should be growing again, its year-on-year GDP growth could be close to 10% and its inflation rate will have turned positive. The arguments in favour of revaluation will then loom much larger. ■

Buttonwood | Something's gotta give



LIKE a truck rolling downhill, the rally in risky assets is proving hard to stop. Good economic news causes share prices to rise because it indicates the recovery is robust; bad economic news also causes prices to rise because it signals that central banks will keep interest rates near zero.

Those low interest rates have probably been the main driver of the rally, encouraging investors to put their cash to work in search of higher returns. But other factors have been at play. Forecasts for corporate profits have been revised steadily upwards as analysts anticipate the benefits of economic recovery.

This has been a revival in the bottom, rather than the top, line. According to Morgan Stanley, non-financial stocks in the S&P 500 beat third-quarter earnings growth estimates by an average nine percentage points. But the companies' sales fell around a point shy of forecasts. A similar pattern was seen in Europe.

In short, companies have used the crisis to achieve a remarkable expansion in margins. Tim Bond of Barclays Capital reckons that, on one measure, the improvement over the last two quarters has been the best since the second world war. The trick has been the corporate sector's success in controlling labour costs; in the third quarter, operating costs for non-financial S&P 500 companies were down by 32% from the previous year.

But the weakness in earnings and the job market means that consumer confidence is far from robust; the University of Michigan sentiment survey has fallen in each of the last two months. Nor are consumers borrowing to maintain their spending; instead they have been repaying their debts.

American retail sales were stronger than expected in October, thanks largely to the car industry. Even so, they were still down on the same month last year. The decline might have been worse had homeowners not benefited from the sharp fall in mortgage rates.

Against such a background, how long can an improvement in corporate profits be maintained? Cutting costs makes sense at the individual company level but not in aggregate; one company's sacked worker or pay freeze translates into another company's sluggish demand.

That may explain why the improvement in profits is not translating into a splurge of capital expenditure. Nevertheless, in the short term, the revival in corporate profits is adding to the sense of recovery. Companies seem to be taking the chance to improve their balance sheets, building up cash reserves instead of repaying bank debt; commercial and industrial loan books are still contracting. And with companies having little need for more debt, banks are indulging their appetite for buying government bonds.

This strategy (with the help of central banks' purchases of bonds) is helping to hold down yields, making it easier for governments to finance their deficits. With inflationary pressures still very low (American core producer prices rose just 0.7% in the year to October), there is very little need for the Federal Reserve to raise interest rates in the near future. The cost of borrowing for six months in dollars is now lower than the cost in yen, something that would have been unimaginable just five years ago.

Instead, the main threat to the rally seems likely to be disappointing growth, at least in the developed world. American industrial production rose just 0.1% between September and October and a number of other industrial-activity figures have been disappointing. The Economic Cycle Research Institute's leading index slipped to an eight-week low in the week to November 6th.

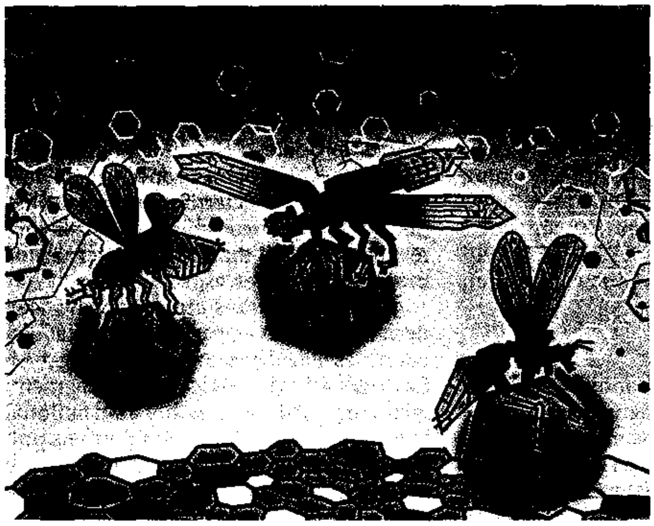
Meanwhile, the Chinese boom that seemed to revive the global economy is showing its dark side. Commodity prices are rising across the board, acting as a further tax on hard-pressed Western consumers (oil has roughly doubled since the start of the year). In some countries, particularly in Europe, actual taxes are starting to rise as well, as governments grapple with their fiscal deficits.

At some point, the central dilemma at the heart of this rally will have to be resolved. Low interest rates seem like good news for investors. But why are central banks holding rates so low? Either they are correct in assessing that the economy is still fragile, in which case corporate profits will ultimately disappoint. Or they are underestimating the strength of the recovery, in which case inflationary pressures will start to emerge (and bond yields will rise sharply). Markets will have a tricky time navigating between this Scylla and Charybdis in 2010.

Economist.com/blogs/buttonwood

Economics focus | Green with envy

The tension between free trade and capping emissions



STATEMENTS by Barack Obama on his travels through Asia have lowered expectations that December's global summit on climate change in Copenhagen will lead to binding cuts in carbon emissions. The urgency of dealing with climate change means that many countries are drawing up national policies to limit emissions. Yet in a globalised world, where production is increasingly mobile across national borders, some worry that there is a fundamental tension between the effectiveness of such policies and a commitment to open trade.

These carbon-reduction policies, such as America's proposed cap-and-trade scheme, typically put a price on carbon in the hope that this will force producers to bear the costs that their activities impose on the climate. But if different countries cut emissions by different amounts, as is likely, then the price of carbon will vary across nations. If so, manufacturers in countries with tighter environmental rules will face added costs which foreign competitors do not. This could in turn prompt them to relocate some of their production to "carbon havens", where the cost of polluting is lower. If enough production emigrates, global emissions might even increase.

The likely scale of relocations may be overstated. A new study* by economists at the World Bank and the Peterson Institute for International Economics, a think-tank in Washington, DC, finds that some production would migrate, but that the net increase in emissions in poor countries would be small.

Just as bananas are best grown in warmer places, imposing a higher carbon price does not compel German manufacturers of capital goods to decamp to China. Also, the increased output of some energy-intensive goods in poorer countries draws some productive resources away from other industries there. Overall, the authors find that if Europe and America were to reduce emissions by 17% from their 2005 levels by 2020, the additional increase in developing-country emissions would be only 1%. Global emissions would still be almost 10% lower than if nothing had been done. So rising global emissions due to carbon leakage are hardly as big a worry as some make them out to be.

That has not stopped many from proposing taxes that would penalise exports from countries that benefit from low carbon prices. From the point of view of countries with stricter environmental rules, it is easy to see why. According to the study, to reduce its emissions by 17% America would have to cut its exports of energy-intensive goods, such as steel, by 12% and its production of such goods by 4%. Domestic producers of energy-intensive goods, on whom much of the burden of adjustment will fall, will demand some form of compensation or protection. No wonder the climate bill passed by the House of Representatives in America has a provision for taxing imports from countries that have laxer rules on emissions. Nicolas Sarkozy, France's president, has proposed that Europe adopt a similar strategy, arguing that not to do so would amount to "massive aid to relocations".

It would be best for trade (and only marginally costly for the environment) if there were no carbon-based tax adjustments. But assuming they were put in place, what might be their effect? That in turn depends on the nitty-gritty: would they be based on the amount of carbon dioxide emitted when making an equivalent good at home, or on the amount actually emitted to make the imported good? The latter would penalise developing countries, because they tend to use much more carbon-intensive technologies. So, if making an American car produced ten tonnes of carbon dioxide, taxed at $60 per tonne, then the tax on a foreign-made car arriving in America would only be $600. But if the tariff were based on the carbon dioxide emitted in the process of making a car in China, it could be double that.

Assuming the economists are ignored...

A tax based on the carbon footprint of imports, the authors reckon, would certainly benefit America's energy-intensive industries, which otherwise bear the full cost of plans to reduce emissions. Their output would fall by only 2.5%, instead of 4%. The trouble is, developing countries would be whacked, since their exports would become markedly less competitive. China's manufacturing exports would decline by a staggering 21% and India's by 16%. The border tax adjustment would amount to a prohibitive tariff of 26% on China's exports and 20% on India's. No wonder that Chinese officials warned angrily of trade wars if border taxes were imposed. A tax based on the carbon footprint of domestic production would be much more benign in its trade effects, reducing China's and India's exports by around 3%.

From a global perspective, the case for a trade tax to reduce emissions is weak. But the politics of shrinking dirty industries in rich countries could well mean that such taxes will be imposed anyway. In the long run this climate protectionism could hurt not only trade but also the environment. Trade promotes the adoption of newer, cleaner technology from rich countries by developing ones, improving the techniques of production in poorer countries gradually over time.

And all countries may find that the inevitable changes in weather patterns due to human activity will mean that meeting varied food needs domestically will become even more difficult. Open markets in agriculture, in particular, will be even more crucial in a world plagued by a changing (and more uncertain) climate than they are now. Keeping trade going will therefore help countries adapt to climate change. The risk is that border taxes are erected to protect energy-intensive industries in the rich world, badly hurting trade—and doing little to help the environment. ■

*"Reconciling Climate Change and Trade Policy", by Aaditya Mattoo, Arvind Subramanian, Dominique van der Mensbrugghe and Jianwu He. World Bank Working Paper No. 5123, November 2009.

Europe's motley leaders

Behold, two mediocre mice

The European Union's choices for its new top jobs reveal a pitiful lack of global ambition

THE Roman poet Horace might have been summing up today's European Union when he wrote that "the mountains will be in labour, and will give birth to a ridiculous mouse." By choosing two virtual unknowns, with paltry political experience, as the first permanent president of the European Council and as the new EU foreign-policy supremo, Europe's leaders have made their union look ridiculous.

Both Belgium's Herman Van Rompuy and Britain's Catherine Ashton are decent in their way. Mr Van Rompuy has been a surprisingly effective Belgian prime minister, holding his fissiparous country together well enough for some to fret over his departure from domestic politics. Lady Ashton piloted the Lisbon treaty through the British House of Lords and has handled the European Commission's trade portfolio without falling out with her colleagues (unlike some predecessors), even if she has no foreign-policy background and has never been elected to anything. Both are suited to the endless rounds of consensus-building that the EU loves and lives by.

That alone is enough for some Europhiles to welcome these appointments. Yet they miss two points. The first is that the Van Rompuy-Ashton team was manifestly nobody's dream ticket. Mr Van Rompuy emerged only because weightier and better-known candidates, including Britain's Tony Blair, fell foul of the objections of one leader or another. Lady Ashton was the third or even fourth choice of Gordon Brown when Britain was offered the post. Picking people for their inoffensiveness, inexperience (both have been in their jobs for only a year), party affiliation, nationality or sex—everything, in fact, except their abilities—is unlikely to lead to the best candidates.

The second mistake is to overlook the aims of the Lisbon treaty. Laboriously pushed through after six years (and three rejections by referendum), it seeks to give the EU a political role in the world to match its economic weight. The permanent council president replaces the present confusing system that appoints a new president from among EU members every six months. The new high representative for foreign policy will have a portfolio (and budget) in the European Commission as well as a large "diplomatic" service. The idea is that the EU should become both more powerful and more accessible for America, China, India and elsewhere.

But it is hard to see the political leaders of America, China and India, or even their foreign ministers, ever taking Mr Van Rompuy and Lady Ashton entirely seriously. Instead they will talk, as now, to their counterparts in big countries like Germany, France and Britain. That will largely vitiate any notion of the EU at last speaking with one voice, or of answering the famously mythical Kissinger question about whom to call when an outsider wants to talk to Europe.

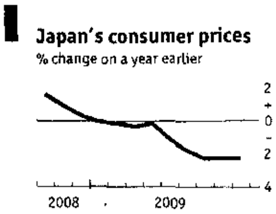
Now every inoffensive Belgian can dream of something

It is just as hard to believe that Germany's Angela Merkel and France's Nicolas Sarkozy wanted such an outcome when they first resurrected the Lisbon treaty from the bones of the EU constitution. They accepted it now mainly to preserve their own grip on the EU. Many Eurosceptics argue similarly, because they prefer nation-states to Brussels. Yet in truth a weak council president and foreign-policy boss will boost the more federalist actors on the EU stage: the European Commission and its president, José Manuel Barroso, and especially the European Parliament. Indeed, the biggest winners in this, as from the Lisbon treaty itself, are the European Parliament and its pan-European parties—despite their feeble democratic mandate (see Charlemagne, page 56). It is enough to make you wonder, yet again, if the treaty was worth ratifying at all. ■

Deflation in Japan

The curse of defeatism

Anybody who thinks deflation is no longer a threat should look at Japan and its flailing authorities



JUDGING by the shrill comments from Wall Street, Japan's biggest problem is its huge public-sector debt, which has grown to nearly twice the size of the country's GDP. But it isn't (see page 76). Far more pressing is deflation.

On November 20th the new government of Yukio Hatoyama acknowledged what has been obvious for months: that prices are falling again after a three-year hiatus. This is worrying not just for Japan; countries such as America and Britain have more similarities with Japan than is commonly acknowledged (see page 77). Sadly neither the Hatoyama administration nor the central bank has shown any intention of tackling the latest incarnation of the deflationary curse.

That is a grave miscalculation. Prices in Japan may not yet be in a downward spiral, but deflation is entrenched: even the Bank of Japan (BOJ) acknowledges that prices may fall for at least another two years. The more they do so, the bigger the burden of Japan's debt becomes, and the more households and firms are likely to retrench. As it is, high real interest rates act as a powerful brake on Japan's incipient recovery.

Japan may have muddled through such scares before, most recently after a five-year splurge of liquidity unleashed by the BOJ between 2001-06. There may be some complacency that ▸▸

▸ because deflation did not spiral downwards then, it will not do so this time. But a few years ago the world economy was strong and Japan could export its way back to health. This time around, global conditions are weaker and the yen is one of the world's strongest currencies. It is a credit to Japan's exporters that they are doing well despite such conditions. Largely thanks to them, Japan's economy jumped forward in the third quarter, though there are already signs that the pace of recovery may be slowing. But to nail deflation once and for all, bolder steps by monetary and fiscal authorities are needed.

The BOJ can start by being more assertive. It is almost as if it is so exasperated by the flaky achievements of its previous anti-deflationary efforts that it would rather sit back and wait for a recovery. But that is a defeatist attitude. If nothing else, it should publicly revive discussion of alternative plans to reflate the economy. That could include increasing government-bond purchases, or setting itself a monetary target not just based on a positive inflation rate, but on robust growth of nominal GDP. If the recovery falters, the BOJ could go further, exploring the use of negative interest rates on bank balances, which would encourage banks to lend money rather than hoarding it at the central bank. Such extraordinary measures would almost inevitably lead to a weaker yen, which would irritate Japan's trading partners. But Japan cannot get out of the deflationary mess if the yen keeps strengthening.

Mr Hatoyama's administration, meanwhile, should stop pestering the BOJ about deflation and face up to its own responsibilities. In the short run that includes keeping fiscal-easing measures in place, at least until there is less deflationary slack in the economy. (So far the government has prevaricated about the need for continued fiscal stimulus.) In the longer term, it should strive to raise Japan's trend rate of growth, which many reckon has fallen to about 1% a year from 1.5-2% previously, as the population shrinks.

That means boosting productivity through labour-market reform, immigration policies and free trade, none of which the ruling Democratic Party of Japan has been keen on so far. Its goal of prompting growth in the underachieving domestic side of Japan's economy is a fine one, and certainly there is room for huge productivity improvements in some areas, particularly agriculture. But that should not come at the cost of harming exporters, which the DPJ has myopically threatened to constrain through union-friendly wage controls.

Big bang-bang

In short, Japan needs a double-barrelled big bang to jolt its economy back to life. If that threatens to spook investors, the authorities should have up their sleeve a credible long-term plan to restore order to public finances—but one which should be put in place only when growth is on a firmer footing and deflation has been truly licked. If the consequence of all this additional stimulus is a weaker yen, so be it. It will be a small price to pay if the eventual result is more openness and buoyancy in one of the world's largest economies. ■

The future of entertainment

Middle-class struggle

More than ever, media is diverging into blockbusters and niches—with everything else struggling

JOE SWANBERG makes films about the romantic lives of young urbanites. He shoots quickly with a digital camera and asks actors to wear their own clothes. His films, which tend to cost between $30,000 and $50,000 to make, are almost never shown in cinemas. Instead they are available on pay-television as video-on-demand, as downloads from iTunes (Apple's digital store) or as DVDs. By keeping his costs down and distributing digitally, Mr Swanberg is making a living.

Technology was expected to help young artists like Mr Swanberg. In 2006 Chris Anderson, the author of "The Long Tail", predicted that the internet would vastly increase the supply of niche media products and bring audiences to them. That has certainly happened. But so has the opposite. In film, music, television and books, blockbusters are tightening their grip on audiences and advertisers (see pages 72-74). The growth of obscure products has come at the expense of things that are merely quite popular. The loser in a world of almost limitless entertainment choice is not the hit, but the near-miss.

There are several reasons for this. Some are as old as Charles Dickens (or perhaps even Homer). People still want to have something to talk about with their friends. Thus "American Idol" and "The X-Factor" do pretty much as well as TV hits did ten years ago, "New Moon" has just set a new record at the box office and bestselling books sell better than ever. Research shows that people enjoy hits more than they do obscure stuff, often because they are the only thing that many people try in that genre: lucky Dan Brown and Katie Price.

But some things are new. All that technology that has made niche content so much more accessible has also proved handy for pushing blockbusters. Missed "Twilight", the predecessor of "New Moon"? There will be other chances to catch it, in a wide variety of formats. Technology helps hits zip around the world, too—even in the art market (see our special report).

Blockbusters are doing well not in spite of the fact that people have more choice in entertainment, but because of it. Imagine walking into a music shop containing 4m songs (the number available on We7, a free music-streaming service in Britain) or more than 10m (the choice on iTunes), all of them arranged alphabetically in plain boxes. The choice would be overwhelming. It is far easier to grab the thing everybody is talking about or that you heard on the radio that morning.

The paradox of choice

Is this increasing polarisation into blockbusters and niches good or bad? It certainly makes life harder for media companies. In a world of growing entertainment options it is more important than ever to make a splash. Miss the top of the chart, even by a little, and your product ends up fighting for attention along with thousands—perhaps millions—of other offerings. That prospect makes for jitters and, sometimes, conservatism. ▸▸

▸ But the authors are blunt about the failings of some notional democracies. They quote a Ugandan judge as saying that "in most African countries, the legislature has, through intimidation, bribery and incompetence, been rendered impotent."

If that study is scathing about democracy in the Commonwealth, the other one, "Common What?", is pretty frank about the club itself. Drawing on polls, focus groups and web chats involving tens of thousands of people, it found that the Commonwealth was more popular among poorer states than richer ones, but misunderstood everywhere. Only about a third of Australians or Canadians would be "sorry" or "appalled" if their country quit the club, though two-thirds of Indians and Malaysians would feel that way.

The Commonwealth's dwindling fan club, it notes provocatively, includes Anglophiles, monarchists and beneficiaries of its scholarships and professional networks; to have any hope of survival, it must expand this constituency by abandoning secretive culture and becoming more open to NGOs and the young.

Some NGOs are not waiting. Well before the bigwigs arrived, they were setting up shop in a People's Forum linked to the summit. One, called AIDS-Free World, called the anti-homosexuality law now before Uganda's parliament a "moment of truth" for a body whose last summit (in Kampala) had spoken in lofty terms about the need to respect diversity. ■

Asma asks the meaning of freedom

Fighting poverty in emerging markets

The gloves go on

Lessons from Brazil, China and India

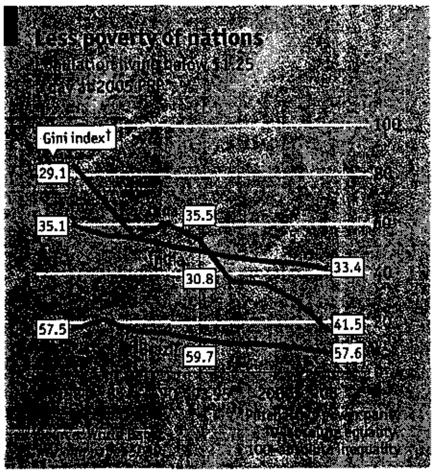
AT THE recent food summit in Rome, President Luiz Inácio Lula da Silva donned a pair of bright-red boxing gloves labelled "Hunger Free" and waved to the cameras. They were his prize—if that is the right term—for Brazil's success in topping a league table drawn up by ActionAid, a British charity, of countries that have done most to reduce hunger*. The occasion was a stunt, of course, but had a serious purpose: to show that even the poorest places can mitigate poverty and hunger. (Brazil is not in that category, but Ghana, Vietnam and Malawi—which came third, fourth and fifth—are.)

ActionAid's list was inevitably influenced by the sort of things that NGOs love: social-protection programmes, constitutional and legal guarantees against poverty, the rejection of free markets. But now comes a more rigorous assessment of poverty-reduction in Brazil, China and India by Martin Ravallion, the director of the World Bank's Development Research Group†. It also suggests that hunger is not simply something that growth will take care of. Mr Ravallion shows that the performance of the giants varies a lot more than their growth. And he too regards Brazil's performance as exceptional.

Between them, Brazil, China and India account for half the world's poorest people and an even bigger share of those who have escaped poverty. In 1981, 84% of China's population was below the poverty line of $1.25 a day (in 2005 prices); in 2005 the share was just 16% (see chart). This amounted to a 6.6% proportionate annual rate of poverty reduction—the difference between the growth rates of the number of poor and the total population.

Nobody did as well as China. Brazil's share of those in poverty fell by half from 17% to 8%, an annual reduction of 3.2%. India did least well, cutting the share below the poverty line from 60% to 42% between 1981 and 2005. This implies an annual reduction of 1.5% a year, though there are problems with Indian statistics; using different consumption figures yields an annual reduction of 3%, comparable to Brazil's.

As Mr Ravallion points out, these figures do not mirror growth rates. Brazil cut poverty by more than India despite much lower growth, just over 1% a year in 1993-2005, compared with India's 5%. If you calculate the rate of poverty reduction for each unit of GDP growth per person, Brazil did even better than China: the ratio is 4.3 for Brazil, 0.8 for China and 0.4 for India (0.8 if you use the adjusted consumption figures). Per unit of growth, Brazil reduced its proportional poverty rate five times more than China or India did.



How did it do so well? The main explanation has to do with inequality. This (as measured by the Gini index, also marked on the chart) has fallen sharply in Brazil since 1993, while it has soared in China and risen in India. Greater inequality dampens the poverty-reducing effect of growth.

Government policy played a big role in reducing inequality. Brazil's main cash-transfer programme, called Bolsa Familia, provides help to 11m families, or 60% of all those in the poorest tenth. In contrast, social security in China is still provided largely through the enterprise system (ie, companies), so it tends to bypass those not in work. And government interventions in India are extraordinarily perverse. People in the poorest fifth are the least likely to have any kind of ration card (the key to public handouts), whereas the richest fifth are the most likely to.

Mr Ravallion concludes with some useful lessons. In all three countries, economic stability made a big difference for the better. China cut poverty the most, but did best early on, when agriculture was growing fastest. As growth shifted towards the cities and manufacturing, inequality rose. It might have done even better with Brazilian-style "progressive" policies. India had both growth and social policies, yet did worst because its policies in fact did rather little to help the poor. With its caste system, and bad state schools, India may be a more unequal society than the numbers alone suggest. Both Asian countries could learn some lessons from Brazil. But Brazil, in turn, will not be able to match China's record in reducing the number of poor people without higher growth. ■

* "Who's really fighting hunger?" www.actionaid.org

† "A comparative perspective on poverty reduction in Brazil, China and India". By Martin Ravallion. Policy Research Working Paper 5080. econ.worldbank.org.

Also in this section

Dubai's debt

Standing still but still standing

Dubai seeks a reprieve on its debts

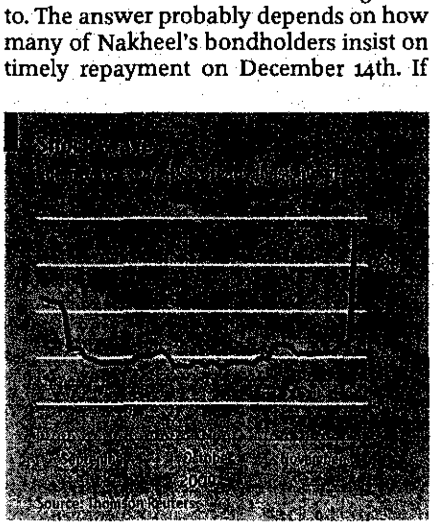
ONE of the biggest events in the Muslim calendar, Eid al-Adha, which begins this weekend, is supposed to be a festival of sacrifice. On November 25th investors in Dubai were given an early chance to get into the spirit of things. The emirate's government asked creditors of Dubai World, one of three big government-backed conglomerates, to agree to a standstill on repayments until May 30th 2010 at the earliest. The standstill does not apply to Dubai Ports World, which operates one of the biggest container terminals in the world. But it does include the $4.05 billion due on December 14th to holders of an Islamic bond, or *sukuk*, issued by Nakheel, a developer responsible for the Palm Islands and other spectacular land-reclamation projects.

The announcement left investors feeling wronged and wrong-footed. Only weeks ago, Sheikh Mohammed bin Rashid al-Maktoum, Dubai's ruler, assured investors that the emirate would soon raise the funds to meet "current and future obligations". Either he was not ready to reveal what was afoot, or he did not know. In an autocratic regime like Dubai, bad news acquires an extra coating of sugar with each step it takes up the hierarchy.

Dubai's debts are heavy, amounting to about $80 billion including the government and the conglomerates it controls. Investors had half-expected Dubai World to seek forbearance from its bankers, asking them to extend their loans. But they felt sure the emirate would make good on publicly traded instruments, and in particular Nakheel's *sukuk*, rather than suffer further damage to its financial reputation.

The dismay of investors was quickly apparent in the market for credit-default swaps (see chart) and in the equally active market for gossip. "Normally we know what's going on," says one sheikh in Sharjah, another member of the United Arab Emirates. "Now we haven't a clue. This smacks of a complete lack of control."

Credit-rating agencies quickly downgraded all government-related debt. Whether the standstill counts as a default depends on whether Dubai is asking investors to defer their claims or telling them to. The answer probably depends on how many of Nakheel's bondholders insist on timely repayment on December 14th. If



push comes to shove, the emirate surely has the means to satisfy many of them. It raised $10 billion from Abu Dhabi, its wealthier neighbour, in February. And hours before it requested a standstill, it said it had raised another $5 billion from two Abu Dhabi banks, although only a portion of that was available immediately.

These bail-out funds flow to the Dubai Financial Support Fund, a committee which is overseeing the restructuring of Dubai's indebted companies. It is described by one banker as a "command-and-control cockpit", imposing some financial discipline on Dubai's government-backed champions.

Dubai sorely lacked such oversight in the run-up to the crash. Indeed, a month ago, bankers worried that the reorganisation of "Dubai Inc" still might not go far enough. Some in the emirate seemed tempted to declare victory over their woes, pretend that every balance-sheet was sound, and go back to business as usual.

But the request for extra time suggests the Support Fund is digging in for a longer campaign. In this stiffening of resolve, some see the influence of Abu Dhabi. Rich in oil and conservative in outlook, its rulers have viewed Dubai's penchant for frolic and folly with distaste and occasional envy. It is possible they are now putting their foot down, fearful that if Dubai does not take its share of pain, it will be back for more money in the next downturn.

Unlike Abu Dhabi, Dubai has to borrow to finance its future. As the recovery takes hold, it will make money again from its property, tourism, trade and financial industries. One banker describes the emirate as an "integrated service industry, no different from a very large Euro Disney". Such an industry can and should carry a certain amount of debt. But it has to learn how to pay for that debt from serving customers, not speculators. ■

Tackling Japan's debt

A load to bear

TOKYO

Japan is not yet doomed to debt-induced penury

IT IS one of the hottest shows in town. People queue up, replace their shoes with slippers, and enter a gymnasium where TV cameras are filming. What they have come to see looks like "Dragons' Den", a popular TV show. But bureaucrats, not entrepreneurs, are the ones begging for cash to fund their pet projects. And politicians give the thumbs up or down.

This is budget-balancing, Japanese-style. The new administration of Yukio Hatoyama has come to office with big spending plans, which it intends to pay for by scrapping wasteful expenditures of the sort that, it says, helped keep its opponents in power for half a century. Judging by the TV audiences, the public is impressed. The trouble is that Japan has a fiscal hole likely to approach 10% of GDP next year, or about ¥50 trillion ($500 billion). Such gestures are like using a toothpick to fill it in.

That means the government may need to issue more bonds next year to bridge the gap, unless there is a strong pickup in growth or the government abandons some of its spending pledges. The prospect of more borrowing has spooked the government-debt market recently. The jitters reflect the sheer size of Japan's public-sector debt, which next year is expected to be twice as big, on a gross basis, as the country's GDP. On a net basis (offsetting the government's financial assets), it is smaller but still among the highest in the OECD.

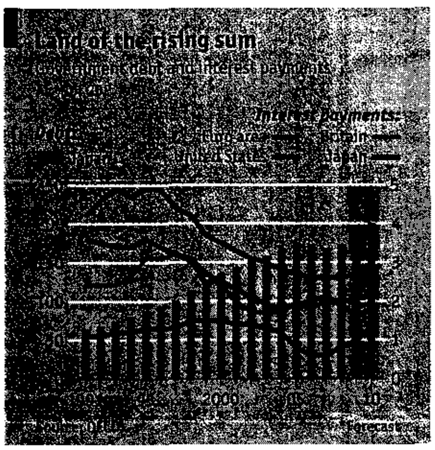
As bond yields edged higher recently, several Wall Street banks issued warnings about potentially crippling debt-service costs. Their case was strengthened by evidence of mounting deflationary pressures and expectations that Japan, with its shrinking population, will be unable to grow fast enough to pay down its debt.

JPMorgan, for instance, has calculated that even if ten-year yields on Japanese government bonds rose by just one percentage point over the next decade (and the fiscal deficit increased each year as a result of social-security and other payments), the government's debt-service costs would triple because of a steadily rising stock of debt. It also said that an ageing-related decline in household savings might lead to a current-account deficit by 2014. That could make Japan more dependent on foreigners for its borrowing needs.

Even the bears acknowledge that there is scant likelihood of Japan blowing up in the short term. There are several reasons to remain calm, notably the remarkable loyalty of Japanese debtholders over the past 15 years. By some estimates more than 93% of Japanese debt is held domestically, which means that the government need never default because it could simply print money to pay the debt off.

This home bias also helps explain why, though the stock of debt is huge, debt-servicing costs as a percentage of GDP have been relatively low compared with Japan's OECD peers (see chart). Even at the peak of their recent run-up, ten-year Japanese-government bonds only yielded a miserly 1.43%, but in a deflationary environment they were still attractive to Japanese investors in real terms. What's more, the government is the world's largest creditor, with plenty of foreign assets to sell. And Japanese citizens are sitting on another ¥1,410 trillion of financial assets. These comfortably exceed the government's debt. As a last resort they could be heavily taxed if the government ran into trouble.

Japan would, indeed, become more exposed to foreign creditors if the current account were to slide into deficit, but that is unlikely unless the world economy takes a turn for the worse and oil prices soar—two things which are unlikely to happen simultaneously. More likely, a worsening current-account balance would weaken the yen, which hit a 14-year high against the dollar on November 26th.

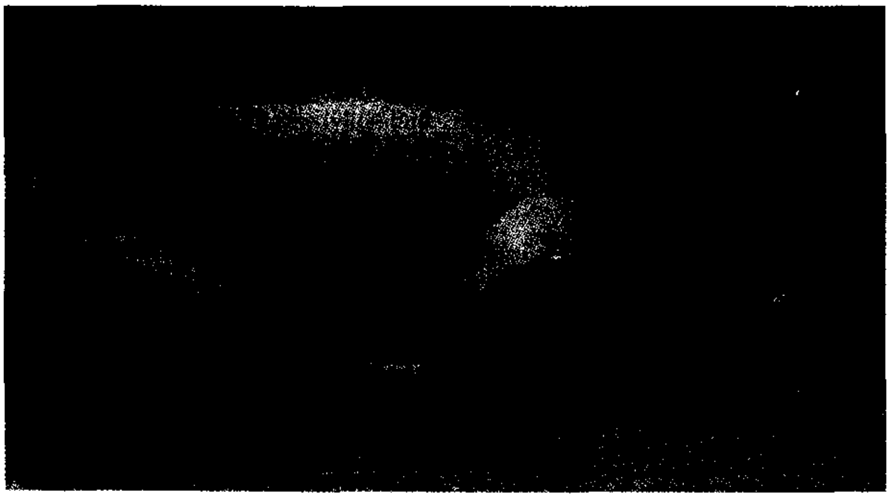


The problem is that even those who remain relaxed about Japan's debt are deeply pessimistic about other aspects of the economy. Deutsche Bank talks of an "iron hexagon" comprising a fiscal deficit, current-account surplus, yen appreciation, falling prices, low nominal interest rates and economic stagnation. "The most realistic path for the Japanese economy is not a crash but a sustained decay or hibernation," writes Mikihiro Matsuoka, its chief economist in Japan.

Hibernation is nothing new. Nominal GDP has increased at an annual rate of 0.1% since 1991. In the third quarter GDP grew at a quarterly rate of 1.2% in real terms, the fastest growth in the G7, but in nominal terms, as a result of the pernicious effects of deflation, it fell by 0.1%. Deflation creates other headwinds. It means real interest rates are abnormally high for a country just emerging from a crunching recession. As long as it persists, the debt-to-GDP ratio will get steadily worse.

That suggests the authorities should take drastic steps to reflate the economy, jolting it out of its stupor and weakening the currency. Yet bizarrely, the Bank of Japan seems to think its credibility is more at risk from reignited inflation than from the stigma of mild deflation. Provided there is no downward spiral in prices, it believes the economy will eventually heal itself.

The Hatoyama administration has barely begun to consider how to prolong the recovery, let alone pay down debt in the long run. It only inserted an "economic growth strategy" into its election manifesto as an afterthought. Analysts believe it is too worried about winning upper-house elections next summer to do anything but pussyfoot on economic policy. Japan needs stimulus in the short term and credible plans for fiscal retrenchment in the long term. At the moment it has neither. ■



Weighed down

Parallels between Japan and the West

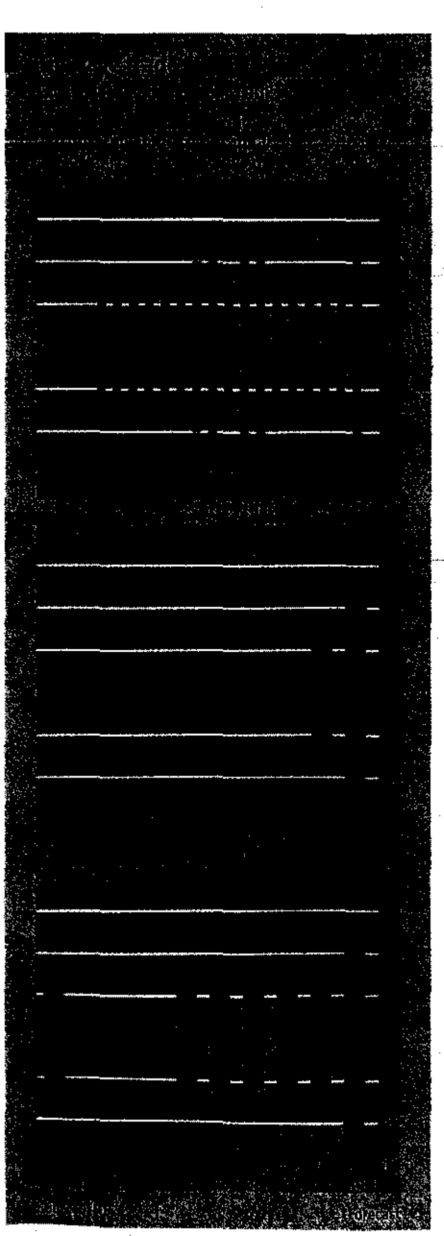
Same chords, different tune

WASHINGTON, DC

There are enough similarities to worry

FOR policymakers in the rich world, Japan's plight is the stuff of nightmares. The damage from the early 1990s property and banking bust lingered for years, devastating the government's finances and, eventually, enveloping the economy in deflation. The effects are still visible.

Small wonder, then, that a desire to avoid Japan's experience has shaped other governments' responses to the financial crash. Their reactions, from the speed and scale with which central banks reached for unconventional monetary tools to the focus (at least rhetorically) on fixing the banking mess, all contrast with the tentative initial response to Japan's bust. But will that be enough? Close inspection suggests that, from America to Britain, worrying similarities with Japan remain. And on some counts today's post-bubble policy challenges are more complex than anything Japanese policymakers ever faced.



Macroeconomically, the main parallel is the massive shift in private and government saving. Japan's asset bust left a gaping hole in corporate balance-sheets. As firms spent years paying down debt, the economy had to be supported by a large and persistent increase in government borrowing (see chart). On average, Japan's government has run a structural fiscal deficit of more than 5% of potential GDP every year since 1993.

The precise contours of the balance-sheet mess are different today: in America, Britain and other post-bubble economies, households have the biggest holes to fill. But the private sector's adjustment has been even more wrenching, with a dramatic shift to surplus mirrored—as in Japan—by a huge increase in public borrowing. And it is far from finished. Even if household balance-sheets are repaired at warp speed, today's post-bubble economies will probably need support from big budget deficits for several years yet.

Faster balance-sheet adjustment also risks a steeper downturn. Despite massive stimulus, today's recessions have been deeper than the aftermath of Japan's bubble. Jobless rates and the amount of slack in the economy are higher, which raises deflationary pressure even as central banks have turned on the monetary spigots. The OECD's latest Economic Outlook estimates America's output gap, the difference between actual and potential GDP, at almost 5% and Britain's at over 6%, both larger than Japan's. And America's 10.2% jobless rate is arguably an underestimate of labour slack. A broader measure, including underemployed workers, has reached almost 18%.

With so much spare capacity, deflation remains a risk even as economies stop shrinking. Although consumers' inflation expectations are stable, professional forecasters now expect slower price growth. According to a survey by the Philadelphia Federal Reserve, forecasters' estimates of ten-year inflation rates have declined, to 2.26% today from 2.5% three months ago.

Optimists point out that Japan made many mistakes, not least the time it took to clean up its banking system. But some of those errors are being repeated today. For all the hoopla about stress tests and financial restructuring, the real strategy in most post-bubble economies is to allow banks to grow their way out trouble gradually, by making fat profits on the back of free central-bank cash. Many impaired assets remain on their books. The result is a dysfunctional banking system, with credit shrinking thanks to lack of supply as well as lack of demand. Latest figures from America's Federal Deposit Insurance Corporation (FDIC) suggest that banks' loan balances fell by 2.8% between July and September, the biggest drop on record. A haul of 552 banks, or 7% of the total, are now on the FDIC's problem list. Britain's bank lending to non-financial firms continued to fall in October.

In America the consequences of this credit crunch are being mitigated, at least for large firms, by the ability to tap the bond market. Gross bond issuance by non-financial firms is running at 55% above its ten-year average. In Britain, too, companies have turned to bond markets in greater numbers but there is less capacity. The capitalisation of Britain's private-sector bond market is the equivalent of 16% of GDP, compared with 120% in America and a G7 average of 50%. As Adam Posen, an external member of the Bank of England's Monetary Policy Committee, recently observed, Britain's dependence on a few big troubled banks marks an "uncomfortable parallel" with Japan in the 1990s.

There are plenty of differences, too. Japan's bust was bigger (its banks' stock of non-performing loans reached 35% of GDP, well above the gloomiest forecasts today). Its macroeconomic adjustment was complicated by a shrinking population. But for years Japan had the advantage of being the only big country in trouble. Today more balance-sheets need repair, the prospects for export-led growth are dimmer, and the increases in public debt will be broader. More broken nights beckon. ■

Pension planning

The retiree's autopilot

A new approach to an old-age problem

IT IS a brave new world of personal responsibility. Private-sector companies have been abandoning their commitment to defined-benefit (DB) pension schemes, in which employees receive an income based on their final salary. The cost of the promise has been too great. But the replacement of DB schemes with defined-contribution (DC) plans hurts employees. Under a DB scheme, it was up to the employer to fill any hole in the fund caused by a market shortfall; in a DC plan, the employee bears all the market risk. If returns are disappointing then pensions will be, too. And employers often use the switch ▸▸

from DB to DC to cut their contributions. If less goes into the pot, less will come out.

Employees in DC schemes can be at a loss when deciding how much to invest, where to put their money and what kind of pension to expect. To avoid this problem, many turn to "target date" funds, which invest in equities in the early years for growth and switch to safer government bonds as retirement approaches. Almost one-third of Americans with personal pensions have assets in such funds, according to the Investment Company Institute.

But this may still put too much emphasis on asset allocation. Robert Merton, a Nobel prize-winning economist, has an alternative approach. He says the main concern for employees is to ensure that switching from work to retirement does not involve a sharp drop in their standard of living. For them the key decisions are: when do they want to retire, how much do they want to save, and what minimum proportion of their final salary, or "replacement rate", do they wish to target?

Under Mr Merton's system—marketed via a company called SmartNest, which is being acquired by Dimensional Fund Advisors, a big fund manager—the employee answers those questions explicitly. The asset allocation of the pension pot is then driven by those decisions—a very high minimum requires a more conservative investment approach. As the market moves, the system keeps employees informed about the probability of meeting their target. If necessary the savings rate or the retirement date may have to change. This approach acts like the satellite-navigation system of a car, automatically replotting the route when the plan goes off course. If it works, the system will help employees avoid a penny-pinching retirement. At the very least it should ensure that they ask the right questions. ■

Buttonwood

Low yields on cash are sending investors far afield

THE hunt for the next bubble is well advanced. Gold, which has repeatedly hit record nominal peaks, is a plausible candidate. Like a dotcom stock, it seems to lack any valuation constraints.

Another option is emerging markets. Equities in developing markets have already enjoyed a phenomenal rally this year, with the MSCI emerging-markets index up by 73% as of November 25th. But what about emerging-market debt?

The credit crunch has shown that emerging markets have not only become the main drivers of global growth but have also replaced developed countries as exemplars of fiscal probity. (Dubai is not technically an emerging market.) The bail-out of the banks, an unexpectedly sharp recession and a collapse in tax revenues have pushed some developed countries into deficits of more than 10% of GDP, figures not seen outside world wars.

The contrast is now striking. Matt King, a strategist at Citigroup, cites IMF figures showing that the debt-to-GDP ratio of the leading 20 developed nations is already twice that of the top 20 emerging markets. By 2014 it will be three times as high.

Every bubble needs a plausible narrative, whether it is the transformative power of the internet or the growth potential of emerging markets. It usually needs easy money as well—and near-zero short-term interest rates in America, Europe and Japan fit the bill, as they encourage investors to search for yield. Bubbles also normally need a trigger event to give them impetus. In this case the credit crunch gave investors cause to doubt the growth prospects of rich-world markets and to favour developing countries.

The bullish argument for emerging-market bonds is based not just on the state of government finances but on the outlook for foreign-exchange markets.

The American government may talk about the desirability of a strong dollar but it seems to have no intention of doing anything about it. Governments in Japan and the euro zone are hardly applauding the resulting strength of the euro and yen. By contrast, argues Mr King, some emerging countries may find their currencies appreciating, no matter what policy they follow.

What if they give in to Western political pressure and allow a modest currency rise? Then investors will speculate that further appreciation is likely. Alternatively countries may choose to intervene in the foreign-exchange markets to prevent their currencies from rising. But the effect of such a policy will be to increase their foreign-exchange reserves (as they sell their own currencies and buy dollars or euros). That will make the country's fundamentals look even more attractive and encourage even greater investment.

In addition, importing loose monetary policy from America (as countries try to peg their currencies to the dollar) may create asset bubbles within emerging markets. Those will attract speculative inflows. And if developing countries try to restrict those bubbles by raising interest rates, that will only make their currencies even more attractive as yield-hungry investors pile in.

The trend is already well under way. EPFR Global, an information group, says that emerging-market-bond funds attracted the largest monthly inflow in October since it began collecting the data in 1995.

Spreads (the excess yield over Treasury bonds), as measured by JPMorgan's index of emerging-market bonds, have fallen from more than five percentage points in October 2008 to less than four percentage points now. To the bulls that leaves room for plenty of further gains: at its narrowest, in June 2007, the spread on this index was 138 basis points (less than one-and-a-half percentage points).

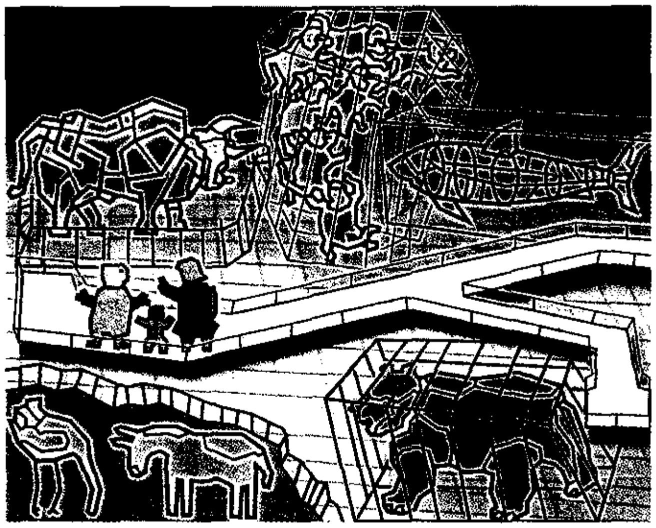
That suggests bubble status is still some way off. To the sector's enthusiasts, like Jerome Booth of Ashmore, a fund manager, talk of a bubble is absurd. The world is witnessing a secular shift in favour of the developing world, which generates roughly 50% of global GDP but is under-represented in investors' portfolios, he says.

Buying emerging-market debt is not quite as straightforward as buying equities. The countries to which investors may most desire exposure (China and India, for example) are underweighted in emerging-market-bond indices relative to the likes of Venezuela and Lebanon. There is also the question of whether to buy debt denominated in local currencies, which is less liquid but carries a higher yield. Regardless of the country's chequered financial history, Brazil's local-currency debt, yielding 11.8%, must look awfully tempting to income-seeking investors at the moment.

Economist.com/blogs/buttonwood

Economics focus | Systems failure

Two new papers explore how to regulate the financial system as a whole



BANKS mimic other banks. They expose themselves to similar risks by making the same sorts of loans. Each bank's appetite for lending rises and falls in sync. What is safe for one institution becomes dangerous if they all do the same, which is often how financial trouble starts. The scope for nasty spillovers is increased by direct linkages. Banks lend to each other as well as to customers, so one firm's failure can quickly cause others to fall over, too.

Because of these connections, rules to ensure the soundness of each bank are not enough to keep the banking system safe. Hence the calls for "macroprudential" regulation to prevent failures of the financial system as a whole. Although there is wide agreement that macroprudential policy is needed to limit systemic risk, there has been very little detail about how it might work. Two new reports help fill this gap. One is a discussion paper from the Bank of England, which sketches out the elements of a macroprudential regime and identifies what needs to be decided before it is put into practice*. The other paper, by the Warwick Commission, a group of academics and experts on finance from around the world, advocates specific reforms**.

The first step is to decide an objective for macroprudential policy. A broad aim is to keep the financial system working well at all times. The bank's report suggests a more precise goal: to limit the chance of bank failure to its "social optimum". Tempering the boom-bust credit cycle and taking some air out of asset-price bubbles may be necessary to meet these aims, but both reports agree that should not be the main purpose of regulation. Making finance safer is ambitious enough.

Policymakers then have to decide on how they might achieve their goal. The financial system is too willing to provide credit in good times and too shy to do so in bad times. In upswings banks are keen to extend loans because write-offs seem unlikely. The willingness of other banks to do the same only reinforces the trend. Borrowers seem less likely to default because with lots of credit around, the value of their assets is rising. As the boom gathers pace, even banks that are wary of making fresh loans carry on for fear of ceding ground to rivals. When recession hits, each bank becomes fearful of making loans partly because other banks are also reluctant. Scarce credit hurts asset prices and leaves borrowers prey to the cash-flow troubles of customers and suppliers.

Since the cycle is such an influence on banks, macroprudential regulation should make it harder for all banks to lend so freely in booms and easier for them to lend in recessions. It can do this by tailoring capital requirements to the credit cycle. Whenever overall credit growth looks too frothy, the macroprudential body could increase the minimum capital buffer that supervisors make each bank hold. Equity capital is relatively dear for banks, which benefit from an implicit state guarantee on their debt finance as well as the tax breaks on interest payments enjoyed by all firms. Forcing banks to hold more capital when exuberance reigns would make it costlier for them to supply credit. It would also provide society with an extra cushion against bank failures.

Each report adds its own twist to this prescription. The Bank of England thinks extra capital may be needed for certain sorts of credit. If capital penalties are not targeted, it argues, banks may simply cut back on routine loans to free up capital for more exotic lending. The Warwick report says each bank's capital should also vary with how long-lived its assets are relative to its funding. Firms with big maturity mismatches are more likely to cause systemic problems and should be penalised. The ease of raising cash against assets and of rolling over debt varies over the cycle, and capital rules need to reflect this. Regulators should also find ways to match different risks with the firms which can best bear them. Banks are the natural bearers of credit risk since they know about evaluating borrowers. Pension funds are less prone to sudden withdrawals of cash and are the best homes for illiquid assets.

The Warwick group is keen that macroprudential policy should be guided by rules. If credit, asset prices and GDP were all growing above their long-run average rates, say, the regulator would be forced to step in or explain why it is not doing so. Finance is a powerful lobby. Without such a trigger for intervention, regulators may be swayed by arguments that the next credit boom is somehow different and poses few dangers. The bank frets about regulatory capture, too, but doubts that any rule would be right for all circumstances. It favours other approaches, such as frequent public scrutiny, to keep regulators honest.

When banks attack

No regulatory system is likely to be fail-safe. That is why Bank of England officials stress that efforts to make bank failures less costly for society must be part of regulatory reform. That includes making banks' capital structures more flexible, so that some kinds of debt turn into loss-bearing equity in a crisis. Both reports favour making systemically important banks hold extra capital, as they pose bigger risks when they fail.

The Warwick group also thinks cross-border banks should abide by the rules of their host countries, so that macroprudential regulation fits local credit conditions. That would require that foreign subsidiaries be independently capitalised, which may also be necessary for a cross-border bank to have a credible "living will", a guide to its orderly resolution. This advice will chafe most in the European Union, where standard rules are the basis of the single market. But varying rules on capital could also be used as a macroeconomic tool in the euro area, where monetary policy cannot be tailored to each country's needs. Regulation to address negative spillovers that hurt financial stability might then have a positive spillover for economic stability. ■

* "The role of macroprudential policy", Bank of England, November 2009
** The Warwick Commission on International Financial Reform, November 2009

WORLD ECONOMY

BY BILL POWELL

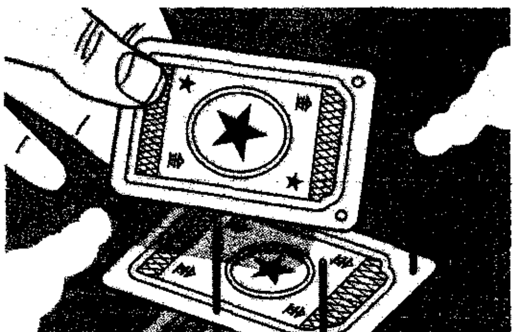
China's House of Cards?

The nation is taking on record levels of debt to keep its economy humming. Some say that can't last.

In a world still awash in economic worry, China has stood apart as the one country that has come through the global slump with only the briefest of hiccups. Last quarter the nation grew at a brisk 8.9% rate, and many economists expect it to expand even faster over the remainder of the year. Profits at large, state-owned companies that have benefited from Beijing's aggressive stimulus program are up sharply. Li Xiaochao, spokesman for the National Bureau of Statistics, summed up the zeitgeist in China these days: "The overall situation of the economy is good."

A lot of global CEOs, of course, are on the thank-God-for-China bandwagon, and it might seem a little churlish to question one of the world's few good-news economic stories. Yet a growing number of observers believe that China is creating its own bubble economy. And they have a case to make.

The U.S. fueled its housing and consumption bubbles by providing easy credit. China seems headed in the same direction, although the victims would be different this time. In the first nine months of the year, Beijing has shoveled $1.27 trillion in new loans into the economy, up 136% from the same period last year. That money has gone to three main areas: infrastructure, manufacturing, and real estate. According to a recent analysis by Monaco-based hedge fund Pivot Capital Management, China's total lending reached 140% of GDP at midyear. That kind of lending makes China an "outlier" compared with other BRIC (Brazil, Russia, India, and China) countries—and is already well beyond the levels that "have led to sharp and brief credit crises in the past," the Pivot Capital report contends.



Moreover, an increasing number of Chinese loans are being funneled into projects unlikely to generate an attractive economic return. From 2000 to 2008 it took just $1.50 in new credit to generate $1 of GDP growth. Now that ratio is 7 to 1. (In the U.S., just before the financial crisis hit, the ratio was only 4 to 1.) That's because the loans are creating huge amounts of manufacturing capacity—which is unneeded in the bears' view. China's spare capacity in the cement industry, for example, equals the total annual consumption in the U.S., Japan, and India combined.

So where will the growth come from? China's export markets are tapped out. Its domestic consumption, stalled at around a third of GDP, hasn't yet started to rise significantly. Additional manufacturing investment would be crazy, leading arguably to a global deflationary bust of epic proportions. Over the past decade China has spent massively on roads, bridges, and other infrastructure. Some economists believe China's infrastructure, already superior to that of many other developing economies, has now passed the point where more investment can contribute much to growth. China, in other words—despite the rosy, headline GDP numbers—might be stuck.

Those bullish on China say the government will keep spending no matter what to keep the economy humming, given its relatively healthy domestic balance sheet compared with that of the U.S. Skeptics reply that if the debt taken on by provincial governments is taken into account, China's fiscal health begins to look questionable.

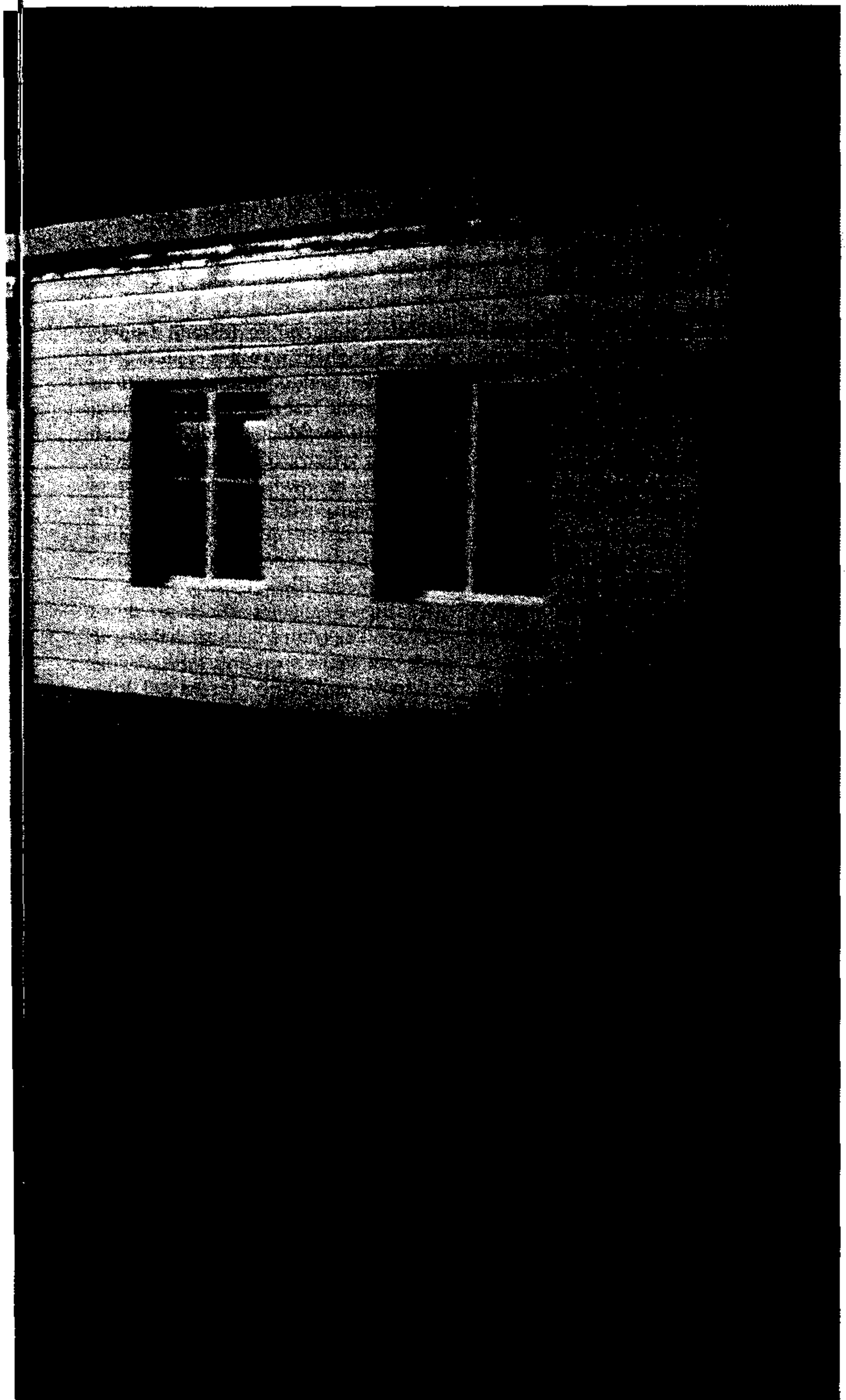
The good news is that the authorities are well aware of the problems. Behind the scenes, Chinese officials are engaged in an increasingly rancorous debate about whether and how quickly to take away the credit-filled punch bowl. Lending has slowed a bit from the red-hot levels in the first half, and recently China's National Development and Reform Commission, a key government policymaking body, said it would begin to deal with excess capacity in key sectors of the economy by forcing mergers and in some cases ordering factories to close.

So, yes, Beijing may be working hard to keep its economy vibrant, but danger lurks out there. Avoiding an American-style meltdown is the economic test that's coming. ◘

FEEDBACK *bill_powell@timeinc.com*

ILLUSTRATION BY HARRY CAMPBELL

NEWSWEEK: NOVEMBER 2, 2009, pp. 43-45.



ASIA

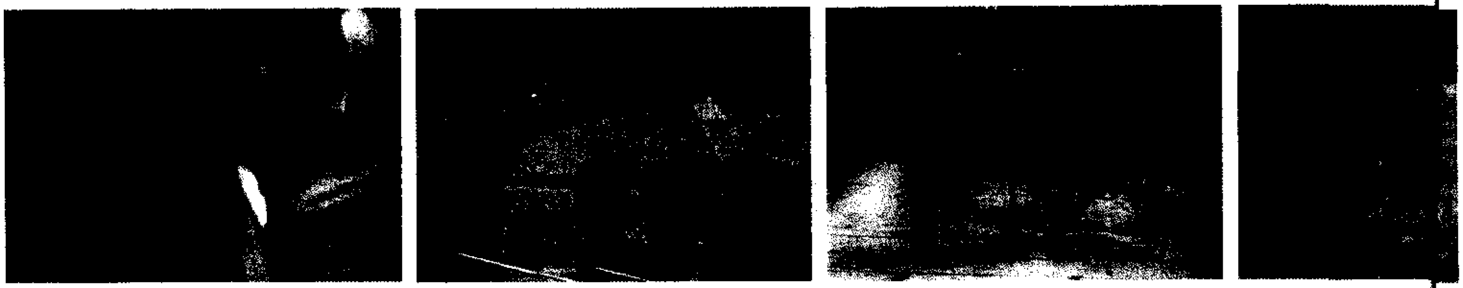
THE SHRINKING OF CHINA

BY DUNCAN HEWITT
PHOTOGRAPHS BY ILKKA UIMONEN

FOR DECADES, RAIL TRAVEL IN CHINA meant an arduous overnighter in a crowded East German-designed train, riding along a rickety old track. Now China is undergoing a rail revolution. Over the next three years, the government will pour some $300 billion into its railways, expanding its network by 20,000 kilometers, including 13,000 kilometers of track designed for high-speed trains capable of traveling up to 350kph. Result: China, a nation long defined by the vastness of its geography, is getting, much, much smaller.

Already, the journey from Beijing to Taiyuan, the capital of Shanxi province, has been slashed from eight hours to three. Shortly before the Olympics last year, the 120km trip from Beijing to Tianjin was cut from almost an hour to just 27 minutes. In the next few years, a train journey from Wuhan to Guangzhou, halfway across the country, will shrink from 10 to three hours. The trip from Shanghai to Beijing, which currently clocks in at 10 grueling hours—and twice that, not so long ago—will be cut to just four, making train travel between China's two most important cities a via-

QUICKLY CHANGING
CHINA, AS SEEN FROM A MOVING TRAIN.



ble competitor to air for the first time. Similarly, a trip from the capital to the southern manufacturing powerhouse of Guangzhou—more or less the entire length of the nation—will take just eight hours, compared with 20 before and more than a day and a half by bus.

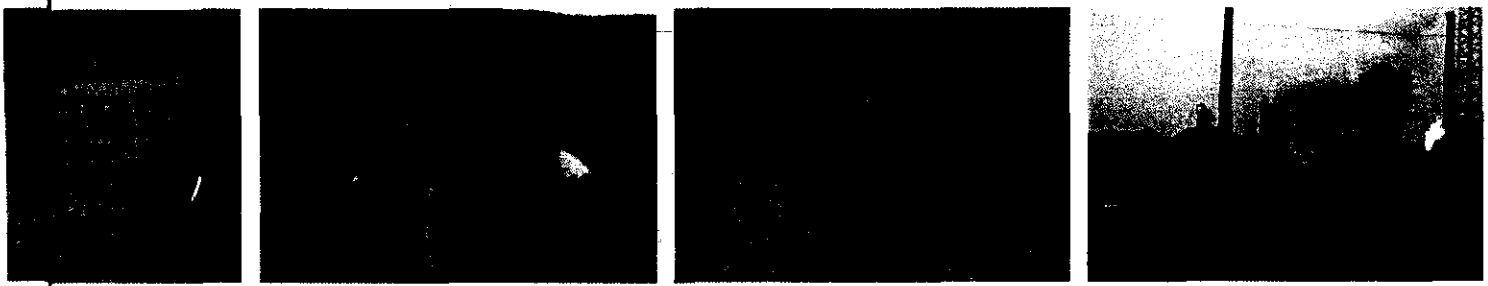
In many ways, China's rail revolution is comparable to the building and opening of America's transcontinental railway in the 19th century or, more recently, to the opening of the U.S. interstate highway system in the 1950s and 1960s. In their own ways, each of those infrastructure projects opened up the United States for development, exploration, and trade. By making travel available to ever-larger numbers of people, they changed not only distances, but individuals' perceptions of their own limitations, shifting "people's mental maps of the land mass in which they lived," says Colin Divall, a professor of railway history at University of York in the U.K.

The advent of high-speed trains is likely to have even greater implications for China, given its larger territory, population, and history of regional unrest. By improving connections, they may help spread economic development more evenly around the country, helping Beijing to bind the nation together and strengthen its hold over the provinces, and decreasing the likelihood that China's internal divisions might one day lead it to fragmenting into "warring states," as some worst-case forecasts have predicted. In particular, the leadership hopes that its call for the nation's talents and industry to "go west" to China's poorer provinces may become easier once western regions become less remote, thanks to rail. Thus the gaps in wealth, status—even dialect—that now divide countryside and city, the more urbanized east and the mostly rural west may be narrowed, advancing Beijing's vision of a more "harmonious society."

Bullet trains are already expanding the definition of a day trip and could help transform isolated backwaters like the inland city of Xian into booming heartland hubs. With traffic already clogging China's expanding network of highways, bullet trains could ease the snarls while opening up travel to the millions of Chinese still unable to afford a car, or a plane ticket. In general, high-speed rail is likely to be just as fast as air travel, at half the price. By shrinking people's sense of the scale of the nation, fast trains may also help stimulate the creativity and new thinking that China needs for the next stage of its economic development. Xie Weida, a professor at the Institute of Railways and Urban Mass Transport at Shanghai's Tongji University, argues that "transport will have a big impact on every aspect of the entire life of our society," stimulating development "not just in the field of economics, but in politics and culture too."

Already, government investment has created something of an economic miniboom. At the railway station in Suzhou—the old Yangtze delta city north of Shanghai famous for its canals and ornamental gardens—teams of construction workers now spend their days suspended precariously from a latticework of girders high above the track. Soon, a brand-new glass-and-steel terminal will rise here, and the crumbling old 1950s station, with its few platforms, will be consigned to history. Guangzhou, Shanghai, and other cities are following suit, building shiny new stations to service the fast new trains. Authorities are so confident about the market that they've invested tens of millions of dollars in localizing production of bullet trains, with 85 percent of the parts for trains in the new Beijing-Shanghai line expected to be manufactured domestically.

Far bigger economic effects are down the line. The train tracks are helping to spur consumer spending, with Beijing residents traveling as far as 120 kilometers to shop in places like Tianjin, where prices are lower. The $8.50 one-way trip takes less than 30 minutes, attracting many middle-class passengers who see the bus—which takes three times as long—as a nonstarter. Beijing's campaign to promote development across regions—like the Yangtse River Delta around Shanghai, or the Pearl River Delta from Guangzhou to Hong Kong—gets a huge boost from the fact that it will soon be possible to traverse these regions in minutes. High-speed rail will cut the trip from Shanghai to Nanjing from what was originally four hours to just 75 minutes. The city of Wenzhou in southeastern Zhejiang—home to many of China's biggest private enterprises, including fashion brands like Meters Bonwe and shoemakers like Aokang—has long been hindered by its relative isolation in a mountainous coastal area. This month it opened high-speed rail tracks connecting it for the first time to Ningbo, a major port, and to the neighboring province of Fujian, an important hub for Taiwanese investment. The link,



which will ultimately extend south to Hong Kong, is expected to further stimulate Wenzhou's legendary entrepreneurial spirit, which has seen it move rapidly from small family workshops to major textile and electronics manufacturing, as well as becoming the source of much of the real-estate investment around China.

The high-speed lines will also help eliminate trade bottlenecks by freeing up space on existing tracks. Paul French, head of the Shanghai retail and logistics consultancy Access Asia, says many foreign businesses are frustrated by the lack of space for transporting goods on China's railways, with freight trains monopolized by shipments of coal and grain. "There's too much investment in passenger rail now and not enough in cargo," he says, noting that this forces companies to add to the number of "overloaded trucks plowing along China's death expressways." But the investment in passenger tracks will allow the old lines to be used for cargo, aiding the Chinese economy by allowing for a more efficient freight-train network. Xie says the government also plans to bolster freight rail with a $40 billion investment on new rolling stock by the end of 2010.

That could put Beijing's policy of opening up the west in high gear. Introduced in 2000 with the aim of binding some of China's poorer western regions to the economic growth of the east coast, thus reducing dangerous social and economic imbalances, the initiative has been hampered by slow and expensive transport connections and the unwillingness of qualified talent to work in remote western regions. The fast-train links may help reduce all of these problems. The ancient capital of Xian has struggled to attract cutting-edge industries to its isolated location, 1,200 kilometers and 10 hours by train from Beijing, but soon that ride will fall to just four hours.

China's effort to develop medium-size cities across the country, in order to reduce the pressure of massive internal migration on big coastal cities, will also get a boost. The fast-rail links include rapidly expanding light-rail connections around major cities, encouraging moves from central cities to smaller satellite towns, or even commutes from one city to another. Retired people seeking a better environment are beginning to do the same.

Still, there is also the possibility that the unifying aim of the high-speed-rail project could create unexpected challenges for Beijing. Some of the fast-train routes are so popular that many passengers can be forced to stand throughout their journey. Outrage over this has led some media outlets to demand that the state-controlled railway system be opened to competition. "Only when monopoly is replaced by free competition," said an article in the *Chengdu Business Daily,* "can we expect real quality train services." What's more, improvements in mobility could begin to undermine the Chinese government's highly restrictive residency regulations, which even today tie people's right to welfare, health care, and education to the place where they were born or have worked during their adult life. Now, according to Mingzheng Shi, head of New York University's teaching center in Shanghai and a specialist in China's urban development, more and more people are moving across old administrative boundaries. "Their concepts of cities and distance are changing," he says. "People from Shanghai see no problem now in living in cities in southern Jiangsu province, where apartments are cheaper, and then taking the fast train to Shanghai in 20 to 40 minutes." Large numbers of urban residents moving away from the cities where their welfare entitlements have traditionally been located may prove too much for the household registration system, and could lead to its "eventual complete collapse," says Shi, removing a vital plank of the state's traditional mechanism of social control.

Over the longer term, easier travel could be the driving force behind a new understanding of what China can one day become. Chinese officials have long argued that the nation's vast area and population make it too unwieldy to be suited to multiparty democracy—and this idea has been deeply lodged in the Chinese psyche for generations. This may have been unsurprising in a country where a couple of decades ago it would often take half a day to get to the next town, and where it could easily take four hours to make a phone call from one city to another. Yet once people begin to sense that their country is getting smaller, those obstacles are likely to seem smaller, too. In fact, the effect of the high-speed trains could be that they do bring China together—just not in the way Beijing might have planned.

NEXT ▶
ECONOMICS VERSUS EXTREMISM
Middle-class Muslims are a powerful weapon.
BY VALI NASR

NEWSWEEK: NOVEMBER 2, 2009, pp. 46-47

MIGHTY MIDDLE
ORDINARY CITIZENS IN IRAN.

GUILLAUME HERBAUT—OEIL PUBLIC

ISLAM | CAPITALISM | REFORM

ECONOMICS VERSUS EXTREMISM

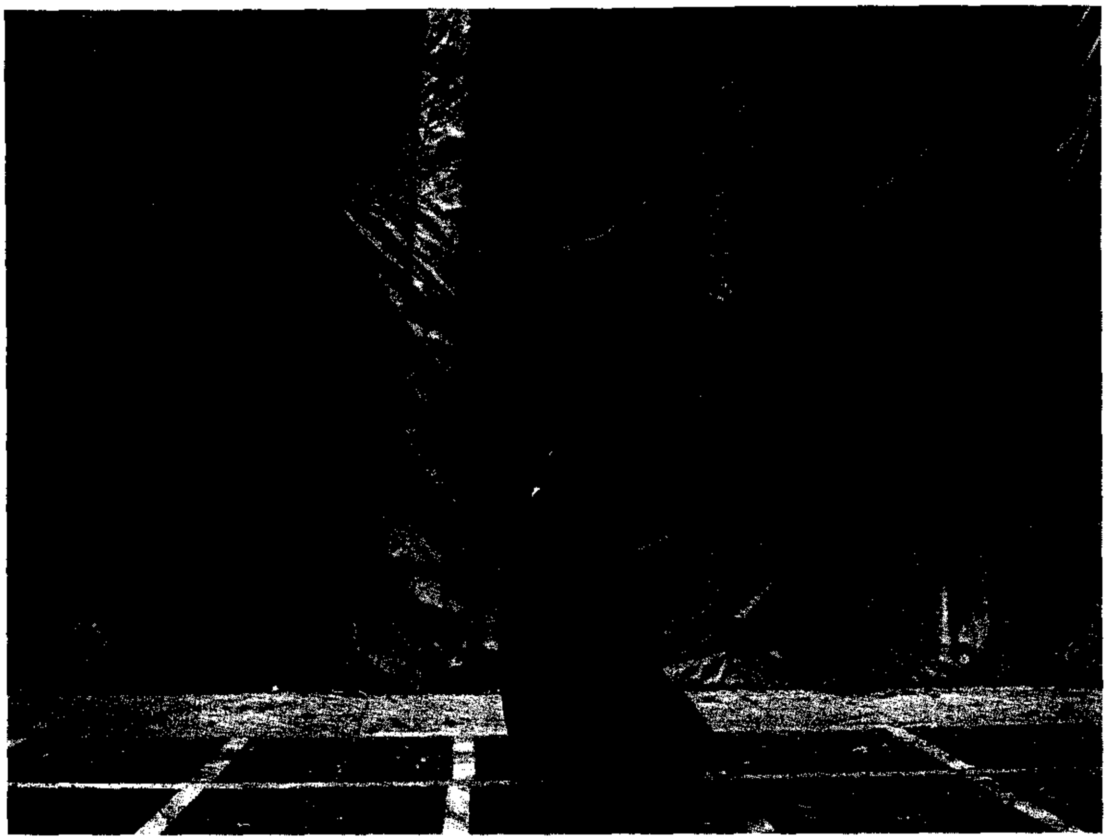
BY VALI NASR

EIGHT YEARS AFTER 9/11, MANY IN THE West still think of Islam as a threat. Islamic extremists are seen as brainwashed robots, and the rest of Muslims as only a step behind in their blind acceptance of what their leaders preach. But this view misses a larger point: Islamic extremism is the direct result not of a problem with doctrine but of sclerotic, overregulated economies that stifle entrepreneurship; isolate people from the global economy; and deprive them of jobs, services, and hope for a brighter future. And there is a glimmer of good news: all this can change. Indeed, it already is. Recent years have seen the tentative emergence of a middle class throughout the Muslim world. And this capitalist trend, if encouraged by the West, offers the single best hope for combating Islamic extremism worldwide.

Consider the problem first. For too long, standards of living have been falling in many parts of the Muslim world. Populations are getting younger, putting more pressure on weak growth rates. By one estimate, the Arab world alone will have to create 100 million new jobs by 2020 to meet the surging demand, and the prospects don't look good. Unemployment is growing, and those lucky enough to have jobs must endure menial, demeaning work. Social mobility is too rare, and extremism thrives on anger and hopelessness. Radical Islam promises despondent youngsters the kind of meaning they can't find in their daily lives. As one Pakistani father of a would-be jihadi told me recently, "Let [my son] be martyred. There is nothing for him here. He has no future. At least if he dies in jihad he will bring honor to his family."

Underneath this gloom, however, one can glimpse sparks of change. Economic reform in Turkey, Dubai, and Malaysia, and even the modest loosening of government control in places such as Egypt, the West Bank, and Pakistan have begun allowing space—though rarely enough space—for commerce and global trade. Local entrepreneurs and businessmen have begun to take advantage of these changes.

The result is the birth of a small but growing middle class. In the 1960s, on average no more than a third of the populations of large Muslim countries such as Turkey, Iran, or Pakistan lived in cities, and by most estimates no more than 6 percent of the populations counted as middle class. Today, around two thirds of the populations of those countries live in urban areas, and on average, twice as many count as middle



GUILLAUME HERBAUT—OEIL PUBLIC

class. If you define the group as those who have a regular income and formal employment with a steady salary and benefits, and who can afford to devote a third of their income to discretionary spending, the middle class now amounts to around 15 percent of the population of Pakistan and twice that in Turkey. The numbers are even higher if you broaden the definition to include those who have adopted modern family values, especially the desire to have fewer children and to invest in their advancement. One estimate puts as many as 60 percent of Iranians in, or ready to enter, that group.

The signs of this emerging middle class and the capitalist surge it's helping to drive can be found everywhere in the Muslim world, even war-torn Beirut and fundamentalist Tehran. While the overall picture in these countries looks grim, an economic renaissance has tentatively begun. Between 2002 and 2008, real GDP in the Middle East and North Africa grew by 3.7 percent, up from 3 percent in the previous decade.

This matters for one key reason: middle-class capitalists represent the best hope for the advancement of their societies—and the most potent weapon for combating extremism. While it's true that the 9/11 attackers were middle class (as have been many other terrorists), what matters is whether or not the middle class as a whole supports extremism. The problem in the Muslim world until now has been that the tiny middle class has had few ties to free markets and has depended on state salaries and entitlements. The growth of local capitalism—and integration with the world economy—could help change that.

Already these forces are having an impact. The recent election controversy in Iran can be seen as a struggle by its rising middle class to protect its economic interests against President Mahmoud Ahmadinejad, a populist who has sought to increase state domination of the economy. Turkey, meanwhile, has already arrived at the future; it is a successful Muslim democracy fully integrated into the global economy.

The same pattern will replicate itself elsewhere. One and a half billion consumers have clout, and as they move up the economic ladder, they demand a blending of traditional and moderate Islam with the opportunities and material benefits of liberal capitalism. They want distinctly Islamic goods: not just halal food and headscarves, but Islamic housing, haute couture, banking, education, entertainment, media, and consumer goods.

This demand has already created waves in global markets, best demonstrated by the boom in Islamic finance (financial services that abide by Islamic rules forbidding the collection and payment of interest). The growth of such services is tying the Muslim world more closely to the global economy. Although it remains a niche market—there are currently some 300 Islamic banks and investment firms operating in more than 75 countries, overseeing banking services totaling close to $500 billion and an Islamic bond market worth $82 billion, a mere one 10th of 1 percent of the global bond market—some estimate that the assets of this sector will grow to as much as $4 trillion by 2015. This trend might look, at first glance, like an attempt to defy the global economy. But what it really represents is an attempt to join it on terms that make sense to Muslims, that combine capitalism with piety.

Some members of this new middle class

CHANGE AGENTS THE MIDDLE CLASS IS DEVOUT BUT MODERATE.

are the children of the old bureaucracy, but a far larger percentage comes from the provinces and from lower social classes. These sons and daughters of the rural poor have made the jump to the middle class by accepting the requirements of modern economics. Many are devout, but their wealth and aspirations put them squarely at odds with extremism. After all, with wealth comes conspicuous consumption, liberal social and political values, and a vested interest in engaging the world. This does not mean there will be no more middle-class Muslim terrorists. But terrorism as a whole will stop resonating with a truly integrated Muslim middle class—a process similar to what occurred in Latin America in the 1990s. Those with a stake in commerce and trade will not subscribe to destructive ideas that endanger their futures. The alienation and rage many Muslims feel toward the West is a product of historical grievances but has been greatly aggravated by their exclusion from the global economy. Were that to change, many Muslims would begin looking forward rather than backward. The rise of this "critical middle" is a trend every bit as powerful and important as extremism. And it holds the key to changing the hearts and minds of the Muslim world once and for all.

It's too soon to say whether Muslim businessmen in Lahore, Tehran, or Cairo will lead a full-fledged capitalist revolution akin to that spearheaded by Protestant burghers in Holland four centuries ago. But European history does suggest that only such actors and the robust breed of capitalism they embrace have a chance of truly modernizing the Muslim world. The modern capitalist West was invented by children of the Reformation, but it was not their puritanical faith that transformed things. It was, rather, their newfound belief in trade and commerce, which took hold in Europe's backwaters like Scotland and gave birth to Adam Smith and David Hume. Similarly today, the agents who will vanquish Muslim extremism will not be secular dictators, enlightened clerics, or liberal reformers but entrepreneurs and businessmen.

This truth has obvious implications for Western governments. Values gain currency when they serve the economic and social interests of the people, and they shape states' behavior when those who hold them gain power. If moderate, capitalist values have not yet been fully embraced in Muslim lands, that's not because of the fundamental nature of Islam, but because the commercial class leading the process is still too small. Helping that bourgeoisie to grow and dominate its societies is the best way of making sure the right values take root.

So what should Washington and its allies do? The first answer is trade. The West has committed much in blood and treasure to protecting its interests in the greater Middle East, yet it does very little real business with the region (apart from Turkey). If you don't count oil and weapons sales, U.S. trade with the whole Arab world amounts to barely a fraction of its trade with Latin America, Eastern Europe, or India. The United States now has free-trade deals with Jordan and Morocco, and Europe is considering an economic partnership with the Arab countries of the Mediterranean rim. These are positive steps, but there are still far too few Arab-made goods on Western shelves.

Trying to reform someone else's religion is a fool's game, and when it comes to nation building, the West's record is spotty. But if there is one thing America and its allies are good at, it is unleashing the transformative power of business. To encourage the middle-class Muslim revolution, therefore, the West should help free Muslim economies from the clutches of state control. Local governments must be pressured to submit to the rule of law, to accept constitutional checks and balances, to open their economies to direct foreign investment, trade, and the free flow of goods and resources, and to reduce regulation. Developed countries should push for fewer and smaller state-run enterprises, reduced public sectors, and fewer people on government payrolls. The West, in return, should open its markets to products from the Muslim world and ensure that the money it pours into the region goes to support the right kind of change.

This won't turn the tide in just a few years. The Muslim world suffers from too many problems. But change is possible, so long as the rich world builds strong ties with the "critical middle" and helps it prosper. The great historical process that changed the West has just begun in the greater Middle East. The United States and Europe must help it along, to ensure that they're standing on the right side of history as it evolves.

NASR *is a professor of international politics at Tufts University and the author of the forthcoming* Forces of Fortune: The Rise of a New Muslim Middle Class and What It Means for Our World, *from which this article was adapted.*

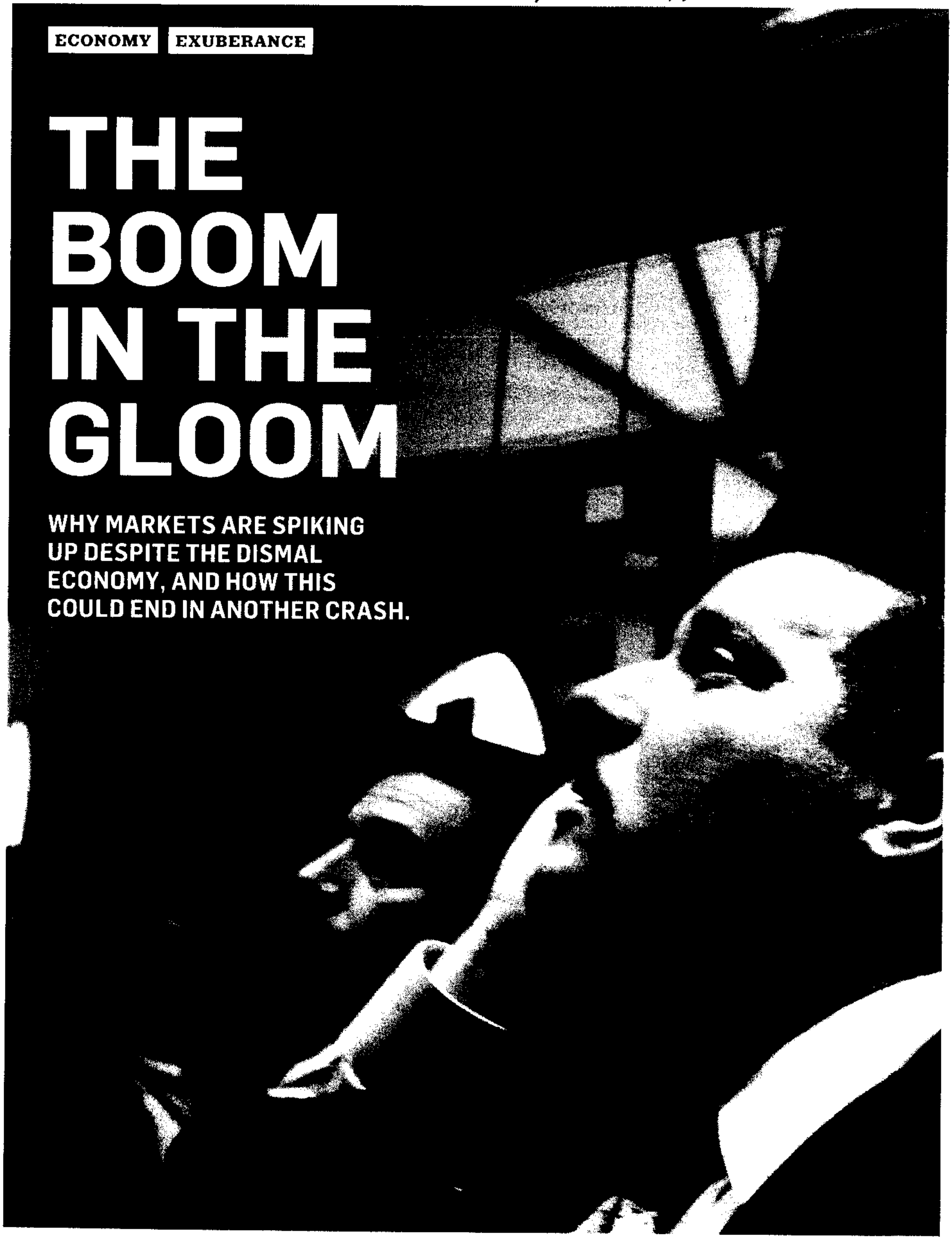
GUILLAUME HERBAUT—OEIL PUBLIC

NEWSWEEK: NOVEMBER 9 2009, pp. 24-27.

ECONOMY **EXUBERANCE**

THE BOOM IN THE GLOOM

WHY MARKETS ARE SPIKING UP DESPITE THE DISMAL ECONOMY, AND HOW THIS COULD END IN ANOTHER CRASH.



BY RANA FOROOHAR

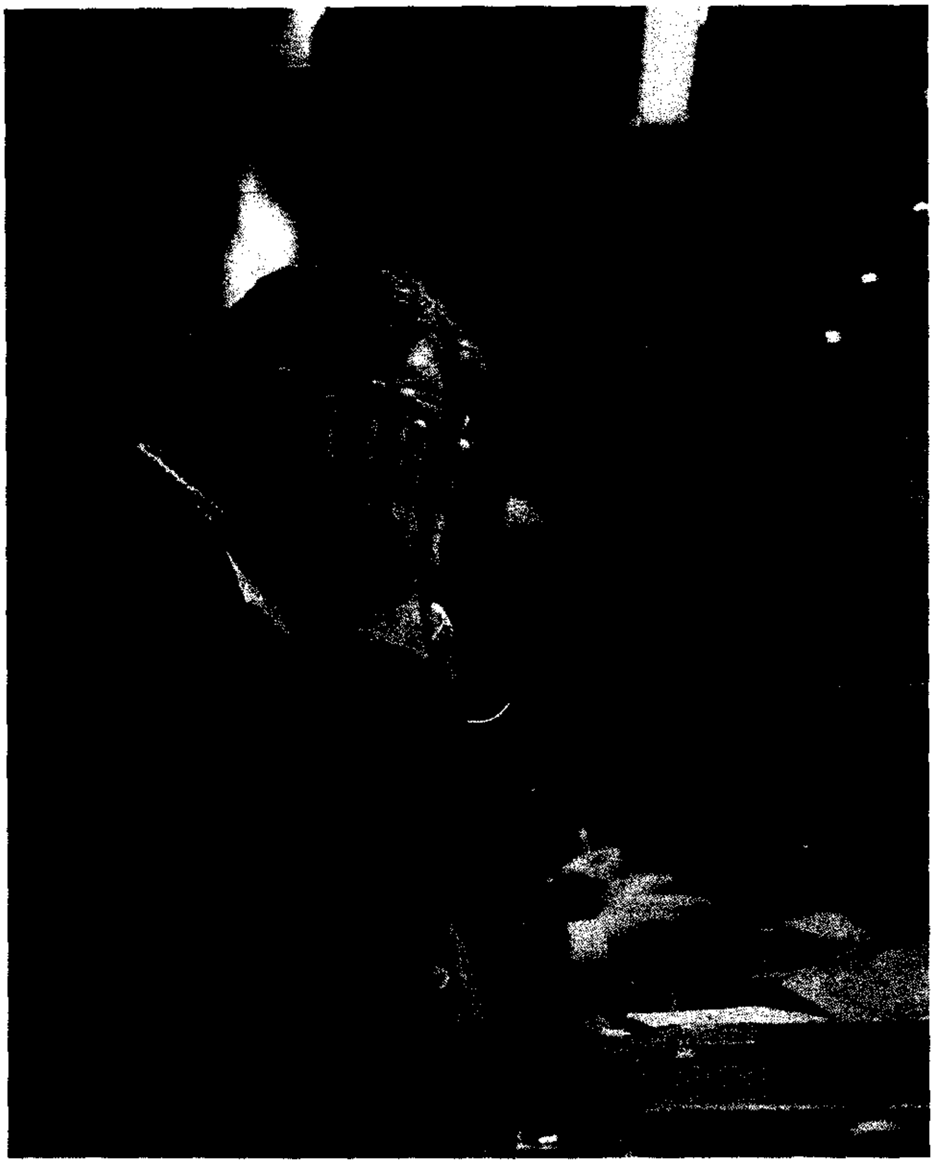
FOR THE PAST SEVERAL MONTHS, investors have been acting like it's 1999, the first year when the Dow crossed 10,000, and stocks took off in complete disregard for reality. Yet the atmosphere then and now couldn't be more different. Back then, stocks were frothier than real businesses, no doubt. But today, American job prospects are the worst in a generation, many state governments are near bankruptcy, consumer credit has all but dried up in the developed world—and global investors see all this as a good sign? It's tough to find an asset class that isn't up, often way up: since the March lows, the S&P has risen by 58 percent; the NASDAQ is up 67 percent. Emerging markets (as measured by the MSCI index) have soared 95 percent. Commodities of all kinds are rising, with crude oil up 132 percent from its February lows and gold hovering around record highs. Although rumblings over banking regulation in Washington last week triggered a dip in financial stocks, the very firms that caused the financial crisis are still leading the industry league standings, up an eye-popping 126 percent since March.

Where is Robert Shiller (the best-selling author of *Irrational Exuberance*) when you need him? In fact, the Yale professor, who accurately foretold the crash of 2001, has just finished tallying the latest Case-Shiller index of top U.S. housing markets, which shows that home prices fell 7.2 percent between December and April, before rising 5 percent between April and August. While historical gaps in data make it tough to track perfectly, Shiller believes we have just seen the sharpest turnaround in American house prices in a century. British and Australian markets are starting to swing up, too, and in many Asian cities, real estate is positively buoyant. How is it possible that home prices are going up again even as employment is going down in most parts of the world, wage growth is nonexistent, and public debt levels are reaching record highs? "We've just gotten very speculative in our behavior, and it's a change that will likely last. I'm inclined to say that we're seeing a new bubble," says Shiller.

Or, more accurately, an echo bubble. It's a term economists use to describe the smaller bubbles that follow on the heels of major ones, usually after the authorities helicopter in loads of cash to patch up the first round of damage, setting the stage for a second round of easy-money-driven speculation. The phenomenon has been observed throughout history, from the British railway bubble of 1830 to the Saudi stock bubble of 2005. Edward Chancellor, author of *Devil Take the Hindmost: A History of Financial Speculation*, says, "Echo bubbles tend to be smaller and fade away faster than the first bubble." On average, they reach about 30 to 40 percent of the size of the original before bursting and sending market values back down to where they should have been all along, wiping out the gains of the echo, but generally not dipping back to the previous low. That implies a Dow falling to 7000 or 8000.

While new bubbles tend to build on entirely new market fads, echo bubbles generally retrace old territory. It's no

ANTONIN KRATOCHVIL—VII



ASHLEY GILBERTSON—VII

'INVESTORS ARE TREATING THE FINANCIAL CRISIS AS THOUGH IT WERE A FLESH WOUND,' NOTES PIMCO'S CEO. 'IT'S NOT.'

accident that today's biggest price spikes are in assets like commodities (which peaked in 2008) and emerging markets (late-2007 peak). "The story of endless global growth, now driven by China and other key emerging markets, is a dream that dies hard," notes Ruchir Sharma, head of emerging markets for Morgan Stanley Investment Management.

The dream ignores the fact that global markets have yet to recover full health after the near-fatal heart attack in credit markets last fall. "Too many investors are treating the financial crisis as though it were a flesh wound," notes PIMCO CEO Mohamed El-Erian. "It's not: the system has been shaken not at the periphery but at the core," he adds, the core being the U.S. financial system. El-Erian believes that as regulatory changes play out, investors will come to see U.S. bank stocks the way they see utilities: dull and slow, not hot and high-growth. The markets are on a "sugar high," he says, and are trading at levels that assume the U.S. recovery will continue unabated, and GDP growth will be in excess of 3 percent. Unfortunately, he adds, that fails to recognize that the recovery "reflects temporary and reversible factors," like the huge stimulus package and inventory rebuilding, rather than a healthy return of private-sector employment and investment. In this scenario, El-Erian says, the U.S. will be lucky to grow by 2 percent.

The reality is that no one can be sure when the private sector will return to health. A good chunk of the profit recently posted by major multinationals has been wrung from cost cutting rather than from new ideas and sales. Banks like Goldman Sachs have pocketed record gains in recent quarters in part because lucrative trading positions no longer attract as many big players, now that so many big players are dead. The risky plays that killed them are still legal because there's been no real cleanup of the world financial sector. Bankers are likely to rack up huge bonuses this year as a result of the echo bubbles, a ringing incentive to indulge the short-term thinking that everyone says is part of the problem. Trading in derivatives and other explosive assets is still largely unregulated, even as governments take on mind-boggling debts in order to shore up the financial systems those assets brought down. It's no secret who'll foot the bill for it all: private citizens and private business. As Nobel Prize–winning economist Vernon Smith puts it, "The Fed has reserved us all!"

These facts are hardly secret: they are well known to anyone who reads the mainstream financial press. Yet the craziness is back, following the familiar pattern of echo bubbles, which are now well documented both in the historical record and in economic lab experiments. In one recent study done by Smith, participants

WHILE THE STATE OF THE GLOBAL ECONOMY IS GENERALLY BEARISH, MARKET POSITIONS ARE DECIDEDLY BULLISH.

were asked to trade an imaginary security, of which the underlying real value was understood. The experimental traders started out underbidding the security but slowly bid it up into a bubble, which then burst. They were subsequently asked to trade the same security again, knowing full well what happened last time around. Nothing changed—except the velocity at which the bubble was created; it happened much faster in the second round. Only in the third round did some participants finally learn their lesson. "We think we can beat the crowd," says Smith with a laugh. "But we are the crowd." It's true not only for the little guy, but also for the world's most sophisticated investors. El-Erian attended a gathering of such people recently, and while the general sentiment about the state of the global economy was bearish, the market positions were decidedly bullish (PIMCO has been reducing risk in its own portfolio).

The only asset class that isn't up these days is fixed-interest government bonds, thanks in part to low interest rates. That policy decision, along with the massive influx of stimulus money around the world, is a key reason for the myriad echo bubbles we are seeing now. "Every asset class is up now, and that's similar to the 2003–2007 bull market, which we now know was driven by a lot of easy money and excess liquidity," says Sharma. Most worrisome is China, where the world's largest stimulus package and $1 trillion in new government lending defines "frothy." Brazil and Russia are spiking in part because they are seen as plays on China's hunger for commodities. Another classic bubble sign: commodities are rising across the board, with oil and copper peaking even as inventories are rising. Investors are not slowing down to make smart choices.

All these bubbles could be quite profitable—as long as you stay on the right side of them. This echo bubble, like those past, is fueled by the fact that there is still a lot of money desperately seeking big returns in global markets. The total amount of financial assets worldwide has fallen from its all-time high of $194 trillion in 2007 to $178 trillion today, according to the McKinsey Global Institute. That $16 trillion in losses is larger than the U.S. economy. But the remaining $178 trillion is still a lot of money, and nearly 60 percent more than the 2000 total of $112 trillion. With interest rates so universally low, investors feel pressured to put that money somewhere. In China, the credit boom has resulted in massive speculation in equity and property markets.

The fallout reverberates back to rich countries. Shiller says the psychological power of the emerging-markets story—and the idea they have now become the world's growth engine—is one likely reason U.S. property markets are ticking back up ahead of the real economy. "People read that emerging markets are still growing, and they think to themselves, hey, we're coming out of recession, property has always been a good investment, and anyway, the Chinese are buying, so why shouldn't I?"

Of course, the value of tech stocks in Shanghai has little to do with that of homes in Miami. No matter: bubbles are inherently illogical, and the timing and scale of their highs and lows are nearly impossible to predict. One thing that history does tell us about echo bubbles is that they always crash and lead to a new cycle of creative destruction, only after which real and sustained growth can once again emerge.

A skittish dip in a number of global markets last week signals that investors probably know all this at some gut level. If ever there has been a heavy bubble, devoid of lightheaded joy, this has to be it. This rally is not driven by giddy investors convinced they are grabbing a piece of the future, but by wary buyers trying to make back their losses, hoping to profit from a government-subsidized gravy train that they know will come to a halt sooner rather than later. "I think the key distinguishing feature between this period and 1999 is memory. Back then, the previous crash was far away. Now you'd have to be an amnesiac not to remember, and that creates a different psychology," says University of Maryland professor Carmen Reinhart. Still, the rally may yet have some legs. Its length will depend on things like the speed with which central bankers start pulling back the stimulus bucks, the possibility of a Chinese banking blow-up, and whether we start to see currency crises resulting from all the new government debt (as some experts, like Harvard professor Kenneth Rogoff and Reinhart, predict). Rogoff and Reinhart, who recently published a book titled *This Time Is Different: Eight Centuries of Financial Folly*, say if that happens, it could well be emerging markets—today's darlings—that will be the victims. If there is any bubble truism to remember, perhaps it's this: the faster they rise, the harder they fall.

With JERRY GUO *in New York*

NEXT ▶
IRAN'S QUIET POWER FAMILY
Meet Ali and Sadeq Larijani.
BY BABAK DEHGHANPISHEH

NEWSWEEK: NOVEMBER 16, 2009. pp. 31-33

MYOP

POLITICS | POWER | INTEGRATION

THE MODEST SUPERPOWER

HOW THE FINANCIAL CRISIS COULD LEAVE EUROPE EVEN STRONGER THAN AMERICA.

BY STEFAN THEIL
PHOTOGRAPHS BY OLIVIER MONGE

IT'S BECOME ALL FASHIONABLE IN Washington, Moscow, and Beijing these days to dismiss Europe as an aging continent in terminal decline. A June report from a Moscow think tank close to the Kremlin described Europe as weak in the face of Russian might, and last year's U.S. National Intelligence Council assessment of global power shifts called the EU "a hobbled giant" plagued by "internal bickering."

Such broadsides are easy to understand. The EU today is divided on all kinds of issues, from how to deal with Russia to the future of NATO. Europe's banks still have more toxic assets on their books than America's. With Britain, France, and Germany often pursuing separate foreign-policy goals, the idea of an EU able to translate its size and wealth into hard power and common purpose seems as remote as ever.

Yet all these critiques miss a stark reality. Even as America and Russia have been humbled by the economic crisis and China and India remain preoccupied with internal problems, Europe is thriving. Exactly two decades after the fall of the Berlin Wall, the continent has been transformed: it is more united, prosperous, and secure than at any time in history. This year, Europe surpassed the United States in wealth, according to the Boston Consulting Group. Next year, Europe's population is expected to hit half a billion and its GDP to nearly match that of the U.S. and China combined. The financial crisis has turned Europe's softer, more regulated brand of capitalism into the preferred model for much of the world—even the United States—and a half-dozen countries are now seeking EU membership in order to gain economic shelter from the ongoing storm. The crisis itself, for all its terrible effects on the EU economy, has unexpectedly strengthened the continent's cohesion, as has the just-ratified Lisbon Treaty, which streamlines the way Europe runs its affairs. Overseas, the EU is now responsible for much of the world's development aid and has 71,000 troops stationed beyond its shores, a global footprint second only to America. This is not to say there aren't many areas where Europe is still divided and punches below its weight. But by most measures, the EU looks better and better by the day.

Predictions of Europe's downfall have a long history of refusing to materialize. In the 1980s one often heard talk of Euro-sclerosis, a crippling malaise of low growth and high unemployment. Since then, European countries have embarked on a reform marathon that, mainly by relaxing labor rules and expanding competition, enabled them to create 9 million more jobs than the United States between 2000 and 2008 and to post a lower unemployment rate (8.9 percent in September, compared with 9.5 in the United States). In the 1990s, the collapse of communism and the disappearance of the Soviet threat led some to predict the fall of NATO and the return of old nationalist ghosts. Those ghosts did briefly rear their heads

SOFT POWER
EUROPE'S STYLE GROWS INCREASINGLY ATTRACTIVE.

in the Balkans. But even they couldn't stop Europe from launching a vast expansion to the east, more than doubling its membership from 12 countries in 1989 to 27 today, while simultaneously deepening its integration. Just a few years ago, it looked as if the EU's older and younger members had developed irreconcilable differences over ties to the United States, the threat of Russia, and the Iraq War. Now that split is fast disappearing, thanks to ever-tighter

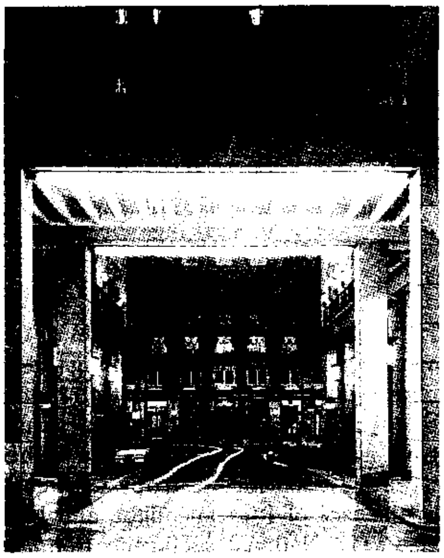
economic and other links, including joint military units, and to what Pawel Swieboda, director of the Warsaw-based think tank DemosEuropa, calls Eastern Europe's "big disappointment" with an American administration that seems to have lost interest in it.

The global economic crisis has again shaken confidence in Europe's future. Because it derives more of its wealth from trade than the United States, Europe was hit harder. But with the start of a recovery, the continental heavyweights, France and Germany, unexpectedly beat America out of the recession, thanks to a rebound in exports and more stable consumer spending. According to the IMF, the United States will experience a stronger recovery than Europe, but only through 2013. After that, U.S. growth will slow to the same rate as the eurozone—2.1 percent—and well below the U.S. average of 3 percent-plus before the crisis. Measured in per-capita terms, the eurozone would grow almost twice as fast as the United States. So much for American parodies of sluggish old Europe.

Many of America's competitive advantages are disappearing. The Wall Street banks and the credit-card culture that did so much to fuel America's boom years are now hobbled, and not likely to recover soon. Government deficits are rising everywhere, but the U.S. deficit is on track to hit 94 percent of GDP next year, compared with 79 percent in the EU. Bob McKee, senior economist at London-based Independent Strategy, says these burdens on the American economy are now long-term strengths for Europe. He also sees Europe's highly globalized companies (five of the world's top ten trading nations are EU members) as better placed than U.S. companies to profit from growth in emerging markets.

On no single issue has Europe rejected rough American capitalism more vehemently than on its treatment of labor. American companies have traditionally enjoyed much more freedom to hire and fire, making them more likely to provide jobs, but also to take them away. U.S. workers had less job security, but also enjoyed much less unemployment. Now that's changing. Columbia University economist Edmund Phelps expects America's "natural" rate of unemployment, long estimated at about 5 percent, to rise to 7 percent or more post-crisis, close to the European "natural" rate of 7.5 percent.

The crisis is also changing perceptions of the EU as incapable of concerted action. When the banking crisis first erupted, the EU's leaders squabbled over bailouts and stimulus measures. Yet at the height of the meltdown this February, as banks and the currencies of smaller EU countries like Hungary and Latvia began to teeter, the European Central Bank stepped in to offer unprecedented emergency credit. And Germany all but guaranteed that richer EU members would prevent any eurozone countries from going bankrupt. That fortified the euro's reputation as the only serious alternative reserve



currency, after the dollar, and is a big reason the euro has risen by 17 percent against the dollar since February. The euro now accounts for a record 27 percent of global reserves, according to Barclays Capital, compared with 18 percent ten years ago, and central banks are now putting 50 percent of new reserves in euros versus 37 percent in dollars.

Europe has even begun to translate its vast economic power into a broader global role. Over the past decade EU members have begun to lead and organize their own peacekeeping missions in places like Bosnia, Congo, Georgia, and Chad—most of them fully independent of the U.S. According to a 2008

THE CONTINENTAL HEAVYWEIGHTS BEAT THE U.S. OUT OF RECESSION, AND EUROPE'S PER CAPITA GDP GROWTH COULD OUTSTRIP AMERICA'S.

RAND Corporation study, these EU-led peacekeeping operations have a 33 percent higher success rate than efforts led by the U.S., based on whether the subject countries ended up peaceful and democratic. The report's author, James Dobbins, says that's largely because U.S. operations tend to be riskier. But the cliché that Europeans play it safe no longer holds. Last month Brussels extended by 12 months its first-ever naval mission in the waters off Somalia, where a flotilla of European warships has foiled some 100 pirate attacks since the start of the year. And the 21 European states with soldiers in Afghanistan have suffered a third of the Coalition's 1,400 combat deaths. Europe could and should do more there—such as send more soldiers and take a more active role in devising the West's strategy—but here again it's important to see the long-term trend. Just a decade ago it would have been inconceivable that pacifist Germany would be fighting a hot war in Afghanistan. Today, more than 4,000 Bundeswehr troops are doing just that.

Europe got another boost last week when the Czech Republic became the last of the 27 members to ratify the Lisbon Treaty, a quasi constitution. The new pact has been dismissed as 287 pages of dense Eurocratese that make only incremental changes. That's true, but steady and incremental is how the EU always evolves. Key innovations include a new EU president to coordinate the union's affairs and new rules to allow more decisions among member-states to be made by majority rather than unanimous voting. That will make it easier to form coalitions of the willing within the union, with different members moving at different speeds. No longer will obstructionist mini-states like the Greek half of Cyprus be able to hold the union hostage with their veto power. Most important, says Andrew Moravcsik, director of Princeton University's European Union program, the treaty resolves the tug of war between so-called federalists who want the EU to become a superstate and Euroskeptics who think it is too powerful already. "The EU has reached its final, mature state," says Moravcsik, "like the American constitutional compromise of 1789." European leaders will no longer be forced to spend time and energy on interminable inner fights over the future of their union.

All this comes just as the world appears to be moving in Europe's direction, according to Mark Leonard, director of the European Council on Foreign Relations and author of *Why Europe Will Run the 21st Century*. Hard power and military nation building have been discredited and constrained by Iraq and rising deficits. On issues ranging from Iran to nuclear disarmament to climate change, negotiation and multilateralism—at which Europe excels—rule.

Now the EU must capitalize on these trends. It must make sure that its biggest weapon for spreading its influence, prosperity, and values—enlargement—keeps moving forward. So far, the continent's leaders have remained dedicated to this project despite tremendous popular opposition. As a result, Croatia recently resolved its last border dispute with Slovenia in order to keep itself on track for accession in 2012. Montenegro and Macedonia have applied—as has Albania, one of Europe's most backward states, which recently proposed becoming the world's first Muslim-majority country to allow gay marriage, just to prove it can meet Europe's standards on civil rights. Even Turkey's candidacy is still moving forward, albeit glacially. While it's true that Turkey has recently begun looking east instead of west, it's a fundamentally reformed and westernized Turkey that is doing so, thanks to decades of changes aimed at winning EU membership.

In only 20 years, the EU has evolved from a loose free market completely dependent on U.S. protection to an ambitious, new-style, uniquely collective power. For the foreseeable future, it will be the only force that can come close to matching the clout of the United States. The EU's modus operandi—sharing power, hammering out agreements, resolving conflict by endless committee—can be boring and even frustrating to watch. But in an increasingly networked and interdependent world, it has become the global standard. "In ten years we're going to wake up and say, wow, they've just solved more problems," Princeton's Moravcsik says. Enthusiasts may exaggerate when they claim Europe will soon run the century. But the skeptics are much further off the mark.

NEXT ▶
INDIA CLEANS UP ITS ACT
Singh's plan to turn it into a global power.
BY JEREMY KAHN

SCOPE **InternationaList**

WORLD LAUGHS AT WALL STREET'S EGO

BY RANA FOROOHAR

Blankfein (right).

FINANCE LAST WEEK, WE GOT MORE proof of Wall Street's utter disconnect from the rest of the world when Goldman Sachs's chief executive Lloyd Blankfein was quoted as saying he's doing "God's work." Apparently, he's also a "blue-collar guy" and "everybody should be happy" that he and his peers are on track to take home billions in bonuses this year. Blankfein's hubris generated disbelief among the foreign CEOs and government officials attending a Chinese business conference, put on by a Swiss outfit called Horasis, in Lisbon last week. "Do you think those quotes might be made up?" one Latin American participant asked.

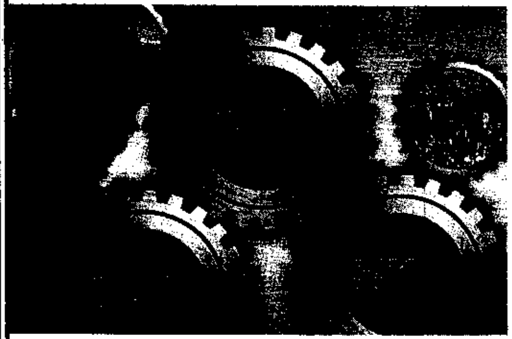
Sadly, no (though Goldman says the God comment was "ironic"). At the same conference last year, right after the start of the financial crisis, there was a surprising lack of ire at the U.S. for causing this mess. Now, with emerging markets surging ahead while rich countries face a low-growth decade, everyone felt emboldened to say what they'd been thinking all along: America is useless. Not only has the U.S. stashed financial bombs under everyone's beds, it's doing a terrible job of cleaning up the mess—and it's certainly not in any position to give economic advice. As Hong Kong real-estate tycoon Ronnie Chan put it: "If we listen to America, we're doomed. Leaders there are pushing aside all the rational voices [calling for greater regulation], and the next crisis is already brewing."

His comments were made during a session on "recapitalizing the world," which quickly turned into a discussion on China. Goldman Sachs itself is now predicting that Chinese GDP will overtake America's by 2027. But already this year, China surpassed the U.S. as the world's largest generator of investment capital, with around $2 trillion to America's $1.4 trillion, according to John Ross, a visiting professor at Shanghai Jiao Tong University. Much of that money is pouring in to markets like Africa and Latin America. Trade deals are often now done in renminbi, and huge commodities buys in such places help China hedge the weakening dollar.

While plenty of financiers in Lisbon were careful to say that the U.S. is still an innovation center, it's clear that BRIC business leaders are looking to each other for future prosperity. China's still-strong growth is the reason that Latin America and Africa, for the first time in modern history, haven't been worst hit by a global downturn. In Lisbon, one Chinese entrepreneur was asked to offer advice to Obama on the eve of his visit to Beijing. His answer: read more about the Middle Kingdom—and get your daughters a Mandarin tutor.

WATCHING THE YUAN

BY RANA FOROOHAR



CHINA IS CHINA FINALLY READY to let its currency rise significantly to reflect its heavyweight status in the world economy? That's what investors have been wondering since the Chinese central bank released a report last week ahead of President Barack Obama's visit to the country, omitting the usual language that Beijing would keep the yuan "stable at a reasonable and balanced level." The relatively low value of the yuan is a key reason that Chinese exports remain so competitive; it's also a reason for major trade imbalances between the United States and China, something that underscored the recent global financial crisis.

But economists say the Obama administration shouldn't expect any big change in the short term. "A token shift [in the currency]is the best I would expect," says Morgan Stanley Asia chairman Stephen Roach, who notes that the recovery is still fragile. What's more likely is that, assuming steady economic growth, Beijing will eventually resume its policy of letting the yuan slowly appreciate, something it had capped last year with the advent of the financial crisis. Currency watchers, take note: if the yuan does start rising steadily again in 2010, it may be a sign that China is confident that it can move away from export dependence, and that its economic recovery is real and lasting.

FROM TOP: DOUG MILLS—THE NEW YORK TIMES-REDUX, TED ALJIBE—AFP-GETTY IMAGES

NEWSWEEK: NOVEMBER 30, 2009

EUROPE'S CAUTIOUS CHOICE

BY ANITA KIRPALANI

EU THE EU SEEMS NEVER TO miss a chance to be boring. Last week, after much agonizing, it decided to fill two top posts created by the new Lisbon Treaty—the European Council president and the high representative for foreign policy—with relative unknowns, Belgian Prime Minister Herman Van Rompuy and Catherine Ashton, a British Labour politician. Critics have already blasted the Union for forgoing big-name statesmen such as Tony Blair for the bland lowest common denominator. But the move may actually turn out to have been the wisest one in the long run. "There appears to be less wind in the sails, but beneath the surface the EU might end up being more united," says Charles Kupchan, a senior fellow at the Council on Foreign Relations. That's because the EU picked people who actually have a chance of fostering consensus, especially on matters such as Iraq or Afghanistan policy. A higher-profile candidate like Blair, while he might have used his star power to bring the bloc a bigger international profile, also risked alienating certain member states—especially given Blair's controversial closeness to Washington and support for the Iraq War. What looks like timidity might just lead to a stronger Europe after all.

CONTROLLING THE CURRENCIES

BY RANA FOROOHAR

MONEY IT'S NO SECRET THAT emerging markets are the place for growth these days. Having not only survived, but thrived, post-financial crisis, nations from China to Indonesia have seen huge inflows of foreign investment in the last few months. While that's good news on many fronts, it also pushes up the value of local currencies, making exports less competitive and labor and other business costs higher, which could threaten growth.

In response, some nations are resorting to capital controls, once a major fiscal no-no. Brazil recently instituted a tax on foreign investment, Taiwan has banned foreign fixed deposits, and Indonesia may limit foreign ownership of many types of assets. With even the IMF saying controls may be necessary to cap the flow of hot money, are we in for a new era of investment protectionism? HSBC senior currency strategist Paul Mackel says no. Recent controls "are less about any statist agenda than a sea change in the global economic environment," in which the U.S. role is waning (as is the value of the dollar) and emerging markets have become growth engines. Mackel says that the change is happening so quickly, nations are using short-term controls for breathing room. But the odds that such measures would continue are slim—there's likely to be a wave of stimulus-backed inflation in the next year or so, and countries will want their currencies to rise in order to combat it. And as more nations cut deals in local currencies, controls will become too cumbersome. If this scenario plays out, it would be yet another sign of how strong the BRICs have become.

BY THE NUMBERS

54 Percentage of global emissions now produced by developing countries.

137 Percentage increase in China's and India's emissions since 1990.

138 Percentage rise in China's per capita emissions since 1991, to 5.8 metric tons per person.

1 Percentage fall in America's per capita emissions since 1991, to 19.9 metric tons per person.

FROM TOP: PAOLO WOODS, JERRY LAMPEN—REUTERS

SAMUEL BOLLENDORFF—OEIL PUBLIC

ESSAY

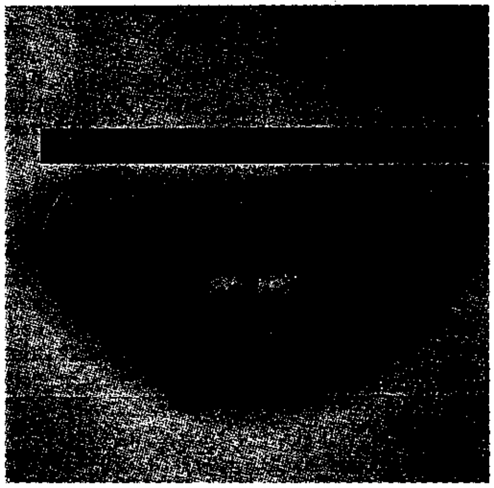
A Better Measure

Our obsession with gross domestic product is unhealthy—and misleading

BY STEPHAN FARIS

FRENCH PRESIDENT NICOLAS SARKOZY DREW HEAT last month when he suggested that countries should factor happiness into their statistics for growth. After all, Sarkozy campaigned on promises of wealth creation, and rejigging the data to include France's welfare system, famously generous holidays, and je ne sais quoi seems like an easy way to fulfill a promise he is struggling to keep.

But what if Sarkozy has a point? After all, the figure at which he was taking aim—gross domestic product—was never intended to gauge anything other than how much money was changing hands. Yet we routinely use economic growth as shorthand for how well a country is doing. If we're going to use a metric to track our progress, shouldn't we choose something that measures the things we care about?



Policymakers have been warning about confusing economic activity with wellbeing ever since the economist Simon Kuznets devised a way to measure that activity at the end of the Great Depression. Kuznets himself warned that "the welfare of a nation can... scarcely be inferred from a measure of national income." Seventy-five years on, GDP feels like an idea whose time has finally passed. "GDP measures, in a certain sense, how much stuff we can produce that we can drop on an enemy," Alan Krueger—now a top-ranked economist in the Obama Administration—said at the Organization for Economic Cooperation and Development (OECD) World Forum in 2007. "It's natural in the post–Cold War era that we would turn to other measures of how well our society is doing."

Natural disasters, oil spills, car crashes, riots, crime: anything you pay to fix will boost GDP. Helping a neighbor up the stairs, skipping work to watch your son's Little League game, strolling in the woods won't. GDP tallies the value of an item, but not the environmental cost of its production: pollution, carbon emissions or the depletion of minerals and ecosystems. "It counts napalm and the cost of a nuclear warhead, and armored cars for police who fight riots in our streets," said Robert Kennedy in 1968. "It does not include the beauty of our poetry or the strength of our marriages; the intelligence of our public debate or the integrity of our public officials."

GDP doesn't even consistently measure what actually gets done. Did you pay a cleaning company to clean your floors? Congratulations, you've added to this year's numbers. Did you scrub them yourself? Sorry, you haven't. Buying eggs from a factory farm: a GDP boost. Raising chickens in your backyard: nope. Forty years ago, buying a VCR to watch a movie at home would have been a significant contribution. Today, picking up a DVD player adds almost nothing. But doesn't the more modern machine provide the better picture?

An overreliance on GDP is not just misleading, it's harmful. Focusing on economic growth blinds policymakers to other measures of progress. "If a policy is going to hurt GDP then it's difficult for that policy to survive," says Jon Hall, who is overseeing a search for better measures of progress by the OECD.

Joseph Stiglitz, the Nobel Prize–winning economist, argues that a single-minded fixation on growth masked the warning signs of the financial crisis. Temporary profits in the financial industry, increasing debt loads, and the real estate bubble all contributed to a false rise in our economic measurements.

Despite its flaws, GDP has proved hard to replace—if only because it provides a single number which nations can use to measure themselves against neighbors and rivals. At an OECD conference in Korea later this month, attendees will try to develop an array of measures that take into account broader definitions of well-being. They have their work cut out for them. While the tiny Himalayan kingdom of Bhutan measures its gross national happiness, no major economy has followed suit.

Starting in 2004, China attempted to introduce a "green GDP," adjusted to reflect the cost of pollution. By the time officials computed the costs of tainted rivers, smoke-filled skies, shattered ecosystems and strip-mined hillsides, their growth figures had dropped so dramatically—in some provinces they fell close to zero—that the proposal was quickly scrapped. By 2007 the effort had collapsed completely.

China's example shows how hard it will be to switch to a more comprehensive measure. But it's also another lesson on how misleading the current figure can be. The numbers that caused so much shock were a better reflection of the country's long-range economic health. It might take time before we find a replacement for GDP. Until then, there's little point in marking our progress against something that's so clearly wrong. ■

ILLUSTRATION FOR TIME BY DANIEL CHANG

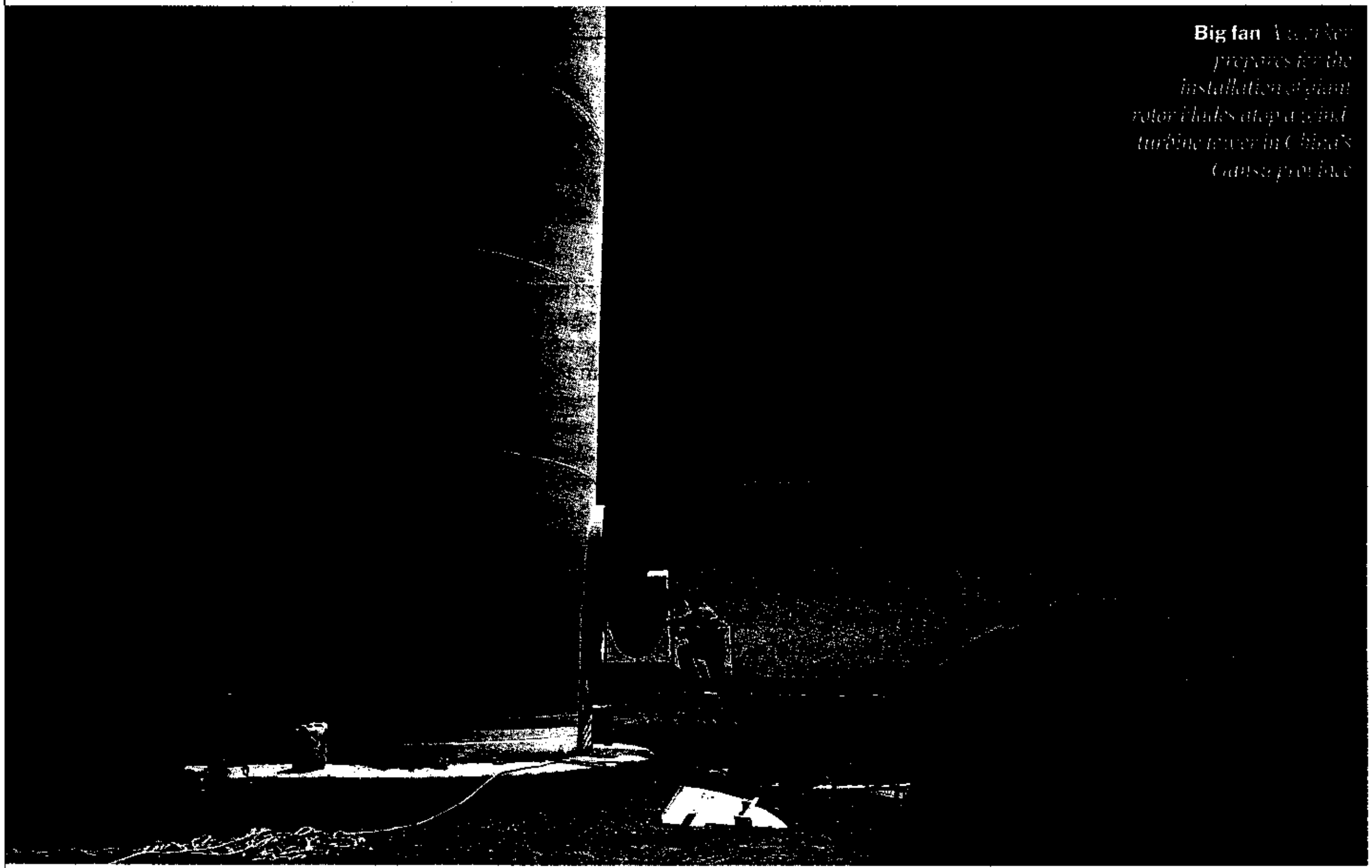
INSIDE

'Using barter we've purchased everything from air-conditioning units, computers and desks to lorries, forklifts and security gates.'

REG BURROWS, MEMBER OF THE BARTERCARD TRADING NETWORK

Global Business

□ FINANCE □ MANUFACTURING □ TECHNOLOGY □ TRADE □ MANAGEMENT □ MARKETS



Big fan *A worker prepares for the installation of giant rotor blades atop a wind turbine tower in China's Gansu province*

ENERGY

Tower of Power. China is fast becoming one of the world's largest alternative-energy markets. But will foreign firms be welcomed?

BY AUSTIN RAMZY

IN CHINA, ONE DOESN'T HAVE TO LOOK far to see the country's commitment to renewable energy. In cities such as Beijing and Shanghai, rooftops are now covered with solar water heaters. On the grasslands of Inner Mongolia, towering white wind turbines are popping up where only cattle, sheep and herders on horseback once roamed. While coal consumption is expected to climb more than 3% annually for the next two decades, the government has also required that electrical companies add a significant amount of alternative energy to their portfolios. With the global economy languishing, China—which is not only the world's most populous country, but also the most polluted—offers the promise that its green-energy drive can become a major source of demand for international wind and solar companies.

That expectation was given a boost in September when First Solar, the Arizona-based solar-module manufacturing giant, announced that it had landed a deal to build a solar field bigger than Manhattan near the city of Ordos, Inner Mongolia. The project will dwarf the largest solar plants to date, and eventually generate enough electricity to power the equivalent of 3 million Chinese homes. To fulfill the huge demands, First Solar says it's considering

ARIANA LINDQUIST—THE NEW YORK TIMES/REDUX

ILLUSTRATION FOR TIME BY JOHN HERSEY

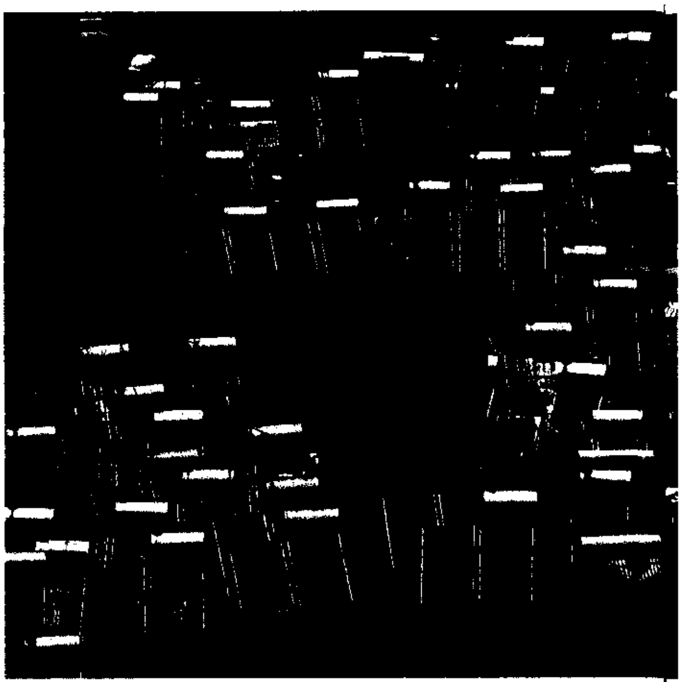
building a solar-module manufacturing facility in the city to support the project. While financial details were not released, news of the deal caused First Solar's stock to jump 11% on the day of the announcement. "This major commitment to solar power is a direct result of the progressive energy policies being adopted in China to create a sustainable, long-term market for solar and a low-carbon future for China," First Solar CEO Mike Ahearn said in a statement.

China, the world's leading producer of greenhouse gases, is taking an aggressive path to develop alternative sources of energy. Already the world's leading generator of hydropower—a renewable but sometimes controversial power source because of the impact on river ecosystems—China now aims to be the front runner in wind- and solar-power generation. In 2007 the government directed that by next year at least 3% of large power companies' generating capacity should come from renewable sources (excluding hydropower); this target jumps to 8% in 2020. That may not sound like much, but according to a recent study by the China Greentech Initiative, a coalition of Chinese and foreign businesses, NGOs and government organizations, environmental technologies including renewable energy could become a $1 trillion market in China by 2013. In a recent commentary, Pulitzer Prize–winning journalist and author Thomas Friedman wrote that China's decision to go green "is the 21st-century equivalent of the Soviet Union's 1957 launch of Sputnik."

The fast-growing country's huge appetite for electricity is behind the push. While China's total power capacity will nearly double by 2020, the amount that could come from wind and solar is expected to jump more than fivefold, aided by significant government assistance. Beijing announced in March it will subsidize 50% of costs for certain solar-panel projects, and 70% in remote regions.

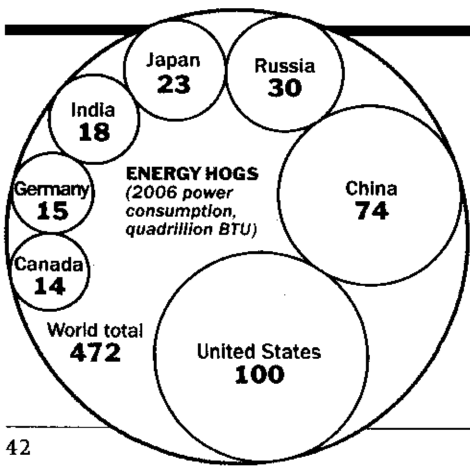
But as often happens in China, this potential bonanza could prove to be a mirage for foreign companies. The country's policymakers are nurturing a domestic alternative-energy industry on a massive scale. China is home to more than 100 wind-turbine manufacturers and some 400 solar-panel companies. The country has quickly grown into the world's largest maker of photovoltaic cells. Yet more than 95% of PV cells produced by China in 2008 were exported, indicating the country's output far exceeds domestic demand. Not surprisingly, foreign companies think they are being blocked from the mainland market. The European Union Chamber of Commerce in China has complained China has erected alternative-energy trade barriers, focusing specifically on the treatment of wind-turbine makers. In a position paper released in September the group said, "The use of bidding requirements to bar international [wind-turbine] companies from competing is a cause for grave concern for these players who have all invested heavily in the market to live up to stringent local content requirements."

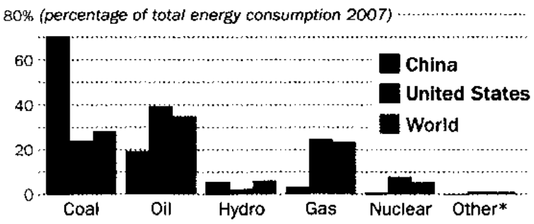
Paulo Fernando Soares, China chief executive for Indian wind-turbine maker Suzlon Energy, says his company has successfully bid for provincial-level projects, but Suzlon and all other foreign firms have been shut out of national-level wind-base projects in Gansu, Hebei and Inner Mongolia. While the Chinese manufacturers are able to sell turbines cheaper than foreign firms, Soares argues they can't match foreign-made equipment in terms of reliability and overall track record. "The Chinese government has decided that they want to develop wind bases, that they want to promote a local industry and that they want to have local suppliers working in those big wind bases," he says. "Then the Chinese government says the foreign companies are so much more expensive than the local companies. If the turbine price is the only selection criteria, then fine. If you take into account risks and performance and tariffs and everything, I

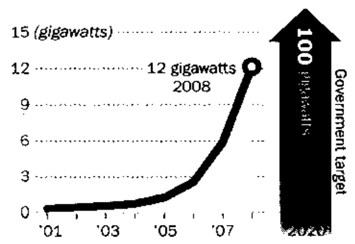


Sunny side up *Solar-powered water heaters, which help cut electricity bills, are proliferating throughout China, right; a technician works on solar-cell assembly at a Suntech Power factory in Wuxi, far right*

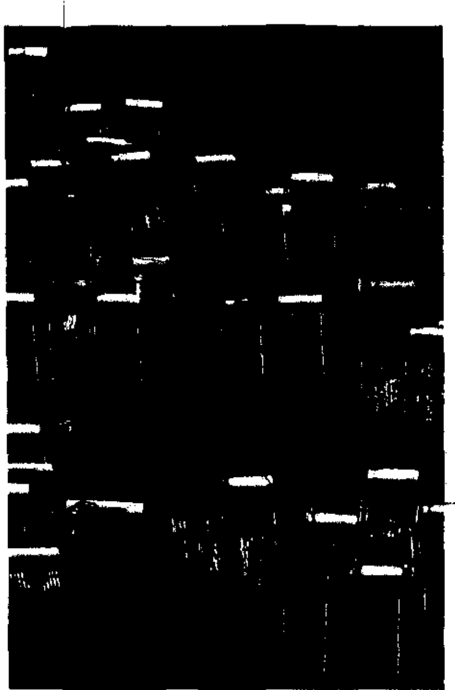
Cleaner Future? China burns a lot of dirty fuel, but green

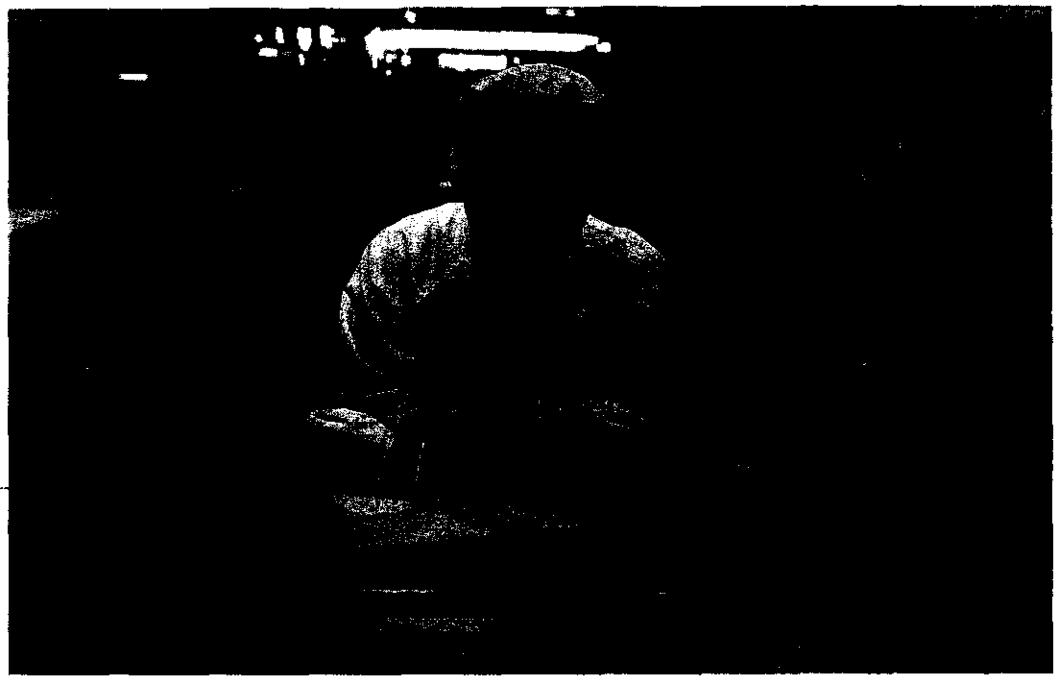






Sources: The World Bank; BP Statistical Review of World Energy June 2009; Energy Information Administration; The China Greentech Initiative analysis; China Wind Power Report;





FROM LEFT: IMAGINECHINA—AP; RYAN PYLE

can tell you in most of the cases, if not all of the cases, the international suppliers are more competitive than the local suppliers."

China's Ministry of Commerce rejected the European chamber's complaints of protectionism, saying the country tries to offer a level playing field for all foreign and domestic businesses. But because China has not signed the World Trade Organization agreement that limits protectionism for government procurement, foreign governments have little recourse. China's National Development and Reform Commission said in June that except in cases where the necessary technology is unavailable domestically, funds from the country's $586 billion stimulus package should buy Chinese-made equipment.

Soares points out that Suzlon has built a factory in Tianjin with more than 900 employees to satisfy Chinese requirements for 70% local parts content in turbines. "They want to promote local industry. But then the question is, What is local?" says Soares. "More than 95% of my employees are Chinese. I'm an investor here, a producer here and pay taxes here. So why is there this difference?" Adding insult to injury, Chinese firms are proving to be tough competitors in markets outside China's borders. In Germany, where government subsidies helped stimulate global solar-panel production, an industry association is investigating claims that Chinese panelmakers are dumping their products. Non-Chinese solar firms complain they are undercut in European and American markets by Chinese companies selling similar products for 30% less than rivals. The dispute has the potential to increase trade frictions between China and the West. Earlier this year, U.S. customs officials ruled that imported solar panels were subject to a duty of 2.5% (panel imports were previously duty-free).

Shi Zhengrong, founder and CEO of Suntech Power, China's biggest solar-panel maker, says his company doesn't sell panels below cost anywhere in the world. And he points to First Solar's Ordos deal as evidence that foreign firms can succeed on the mainland. "As long as companies have a competitive renewable-energy technology and product offering," he says, "there will definitely be opportunities in the Chinese market."

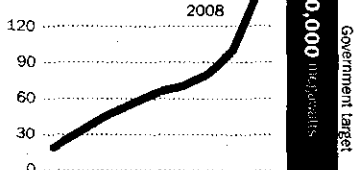
Some overseas firms insist that China is simply repeating an economic development strategy that has propelled the country's rapid progress in many other manufacturing sectors. The country has been able to use the lure of huge potential markets to entice foreign companies to hand over technology and know-how in exchange for lucrative deals, later using that knowledge to produce competitive products cheaper than those of overseas originators. Foreign companies built the generators for the first stage of the massive Three Gorges hydroelectric dam, but the generator contracts required the foreign makers to transfer technology to Chinese partners, who took the lead in later phases of construction. A similar pattern appears to be playing out in alternative energy. Foreign wind-turbine manufacturers held nearly 60% of the Chinese market in 2006. By last year that position was reversed, with Chinese firms taking 74% of new installations, says Jun Ying, chief China representative for the consulting firm New Energy Finance. In fact, the number of Chinese turbine manufacturers has expanded so rapidly that the government, fearing a glut, warned in October that applications for new factories might not be approved.

Given the number of foreign companies that have set up their own facilities in China, the government is unlikely to let them fail completely, says New Energy Finance's Ying. "If they have manufacturing capacity in China, they generate GDP, generate tax revenue, generate employment, I do not see a reason why the Chinese government would let them die," he says. "A parent may like one child more than the other, but at the end of the day I think they will continue to do well and continue to do business in China." With the rest of the global economy still stagnating, life as China's stepchild may be the best some international firms can hope for. ■

en

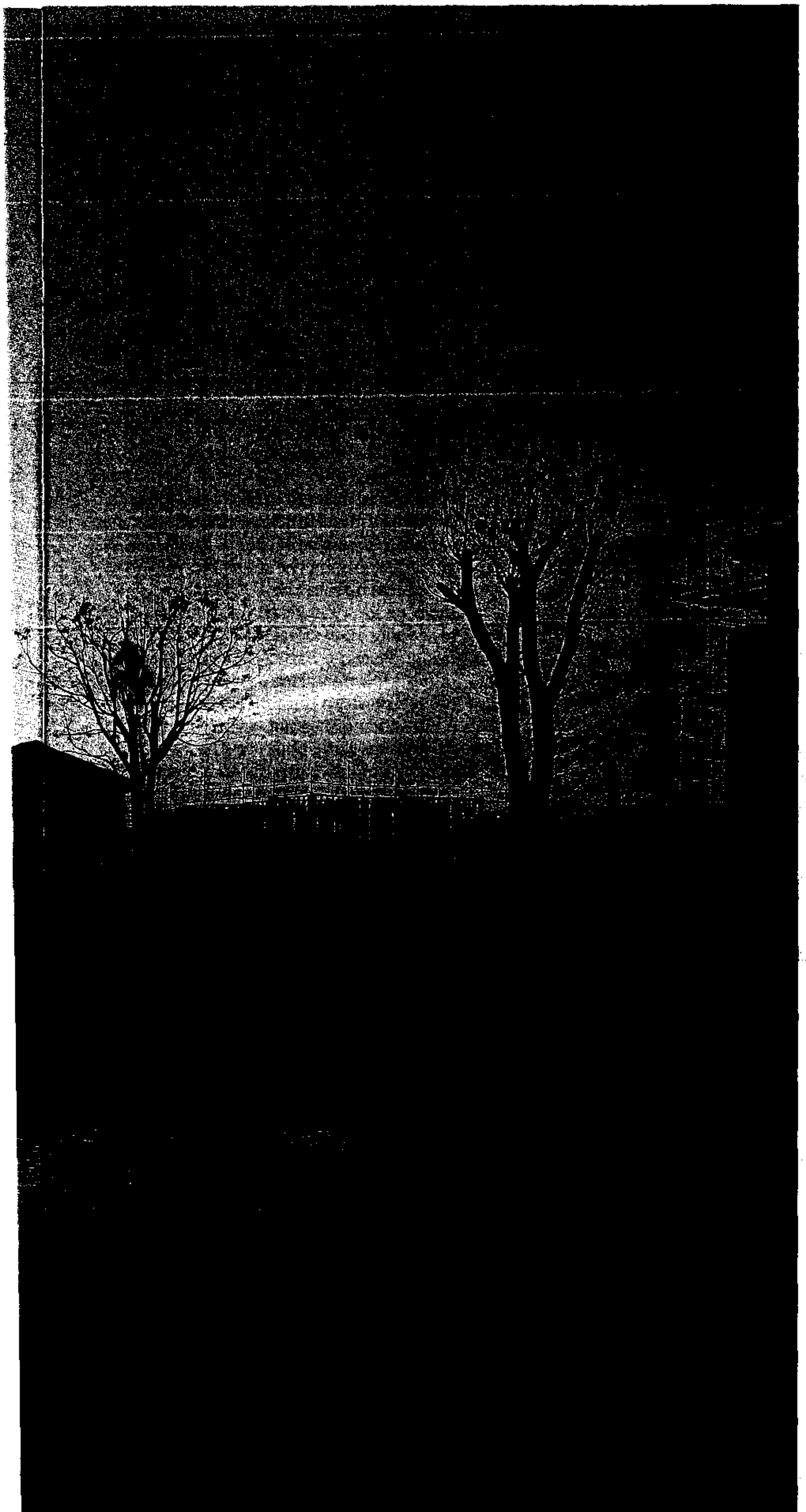
sources are growing

CHINA'S SOLAR-POWER CAPACITY



r Report; Renewable Energy World. *Includes solar, wind, geothermal and biomass

TIME: NOVEMBER 23, 2009, pp. 25-31.



Photographs for TIME by Daniel Traub

5 Things the U.S. Can Learn from China

While the U.S. remains mired in an economic funk, the Asian giant drives ceaselessly forward. On the eve of Obama's first visit there, a look at what the world's rising power can teach America now

BY BILL POWELL/SHANGHAI

Building momentum *Masons at work in front of the China Pavilion at the future site of Expo 2010 in Shanghai*

ON THE EVENING OF NOV. 15, President Barack Obama, the youthful leader of one of the world's youngest countries, begins his first visit to China, among the world's most ancient societies. Obama and his Chinese counterpart, Hu Jintao, have much to discuss. Nukes in Iran and North Korea. China's surging military spending. Trade imbalances. Climate change.

But the visit comes at an awkward moment for the U.S. China, despite its 5,000-year burden of history, has emerged as a dynamo of optimism, experimentation and growth. It has defied the global economic slump, and the sense that it's the world's ascendant power has never been stronger. The U.S., by contrast, seems suddenly older and frailer. America's national mood is still in a funk, its economy foundering, its red-vs.-blue politics as rancorous as ever. The U.S. may be one of the world's oldest capitalist countries and China one of the youngest, but you couldn't blame Obama if he leaned over to Hu at some point and asked, "What are you guys doing right?"

Could the world's lone but weary superpower actually learn something from China? It's a politically incorrect question, of course. China is an authoritarian nation; its ruling Communist Party deals ruthlessly with any challenge to its hegemony. It remains, relatively speaking, a poor, developing country with huge problems to confront, massive corruption and environmental degradation being Nos. 1 and 1a. Still, this is a moment of humility for the U.S., and China is doing some important things right. If the U.S. were to ask the Chinese what it could learn from their example, it might gain some insight into what it's doing right and wrong. Here are five lessons from China's success story:

LESSON

1 一

Be Ambitious

ONE DAY THIS SUMMER, SEAN MALONEY, an executive vice president at Intel, was bouncing from one appointment to another in northeastern China, speeding along in a van traversing newly built highways. He gazed out at one of the world's biggest construction projects: a network of high-speed train lines—covering 10,000 miles (16,000 km) nationwide—that China is building. As far as the eye could see, there sat vast concrete support struts, one after another, exactly 246 ft. (75 m) apart. Each was full of steel cables and weighed about 800 tons. "We used to build stuff too," Maloney mused, unprompted. "But now it's NIMBY [not in my backyard] every time you try to do something. Here," he joked, "it's more like IMBY. There's stuff happening here, everywhere and always."

It's not just NIMBYism that constrains the U.S. these days, of course. America is close to tapped out financially, with budget deficits this year and next exceeding $1 trillion and forecast to remain above $500 billion through 2019. But sometimes the country seems tapped out in terms of vision and investment for the future.

'One key thing we can learn from China is setting goals, making plans and focusing on moving the country ahead.'

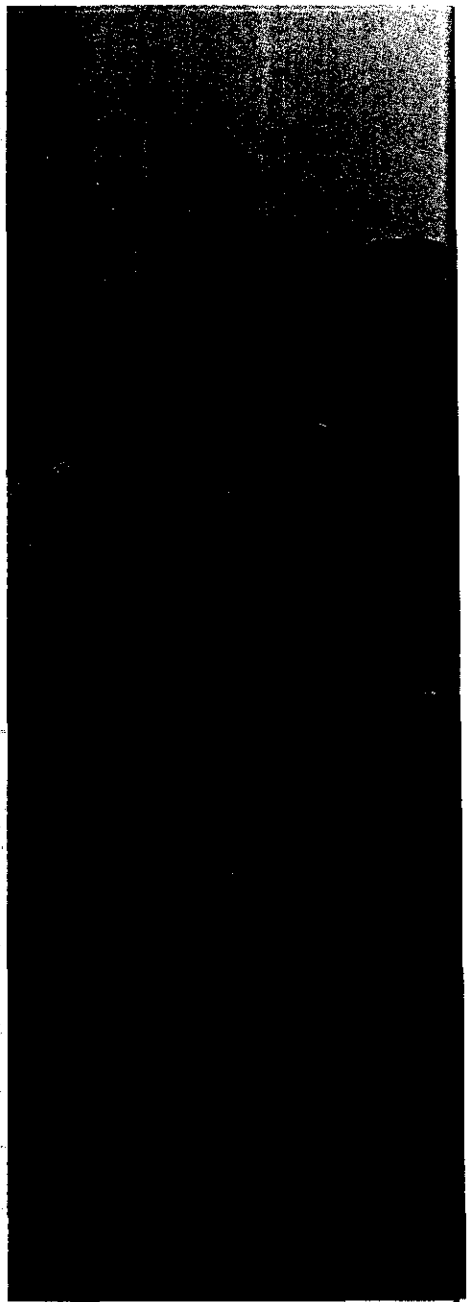
—JAMES MCGREGOR, FORMER CHAIRMAN, AMERICAN CHAMBER OF COMMERCE IN CHINA

Some economists believe that given its stage of development, China spends too much on expensive items like high-speed rail lines. But step back from the individual infrastructure projects and the debates about whether a given investment is necessary, and what's palpable in China is the sense of forward motion, of energy. No foreigner—at least not one I've met in five years of living here—even bothers denying it. And the Chinese take it for granted. When a brand-new six-lane highway opened in suburban Shanghai in October, Zhong Li Ping, who shuttles migrant workers to the city and back to their hometowns, said, "I don't know what took them so long." In truth, it took about two years—roughly the time it would take to get the environmental and other regulatory permits for a new highway in the U.S. If, that is, you could get them at all.

There's no direct translation into Chinese of the phrase *can-do spirit*. But *yong wang zhi qian* probably suffices. Literally, it means "march forward courageously." China has—and has had for years now—a can-do spirit that's unmistakable. Americans know the phrase well. They invented it. It used to define them.

Critics of the authoritarian Chinese government would say it's a system more accurately called "can do—or else." And they have a point. No one in the U.S. would argue that it should adopt China's dictatorial style of government. America doesn't need to displace tens of thousands of people in order to build a massive dam, as China did in Hubei province from 1994 to 2006. (The value of checks and balances is, in fact, among the many things China could learn from the U.S.) But you don't have to be a card-carrying communist to wonder how effectively the U.S. develops and executes ambitious projects. Ask James McGregor. He's a former chairman of the American Chamber of Commerce in China and now a business consultant who divides his time between the two countries. "One key thing we can learn from China is setting goals, making plans and focusing on moving the country ahead as a nation," he says. "These guys have taken the old five-year plans and stood them on their head. Instead of deciding which factory gets which raw materials, which products are made, how they are priced and where they are sold, their planning now consists of 'How do we build a world-class silicon-chip industry in five years? How do we become a global player in car-manufacturing?'"

Some of this is the natural arc of a huge, fast-growing country in the process of modernization. The U.S. in the late 19th century was nothing if not what Intel's Maloney would call an IMBY country. America was ambitious. There's no secret formula to help the nation get back its zeal for what it used to enthusiastically and sincerely call progress. But even though the U.S. is a mature, developed country, many economists believe it has shortchanged infrastructure investment for decades. It possibly did so again in this year's stimulus package. Just $144 billion of the $787 billion stimulus bill Congress passed earlier this year went to direct infrastructure spending. According to IHS Global Insight, an economic-consulting firm, U.S. spending on transportation infrastructure will actually decline overall in 2009 when



Bright ideas *China's schools are adding more creative and practical topics to their notoriously rigid curriculums*

state budgets are factored in—this at a time when the American Society of Civil Engineers contends that the U.S. should invest $1.6 trillion to upgrade its aging infrastructure over the next five years.

When the economic crisis hit China late last year, by contrast, almost half of the emergency spending Beijing approved—$585 billion spread over two years—was directed at projects that accelerated China's massive infrastructure build-out. "That money went into the real economy very quickly," says economist Albert Keidel of the Carnegie Endowment for International Peace.

But it's not just emergency spending on bridges, roads and high-speed rail networks that's helping growth in China. Patrick Tam, general partner at Tsing Capital, a venture-capital firm in Beijing, says the government is aggressively helping seed the development of new green-tech industries. An example: 13 of China's biggest cities will have all-electric bus fleets within five years. "China is eventually going to dominate the industry for electric vehicles," Tam says, "in part because the central government has both the vision and the financial wherewithal to make that happen." Tam, a graduate of MIT and the University of California, Berkeley, says he does deals in Beijing rather than Silicon Valley these days "because I believe this is where these new industries will really take shape. China's got the energy, the drive and the market to do it." Isn't that the sort of thing venture capitalists used to say about the U.S.?

LESSON

2 ≥

Education Matters

ON A RECENT SATURDAY AFTERNOON, AT a nice restaurant in central Shanghai, Liu Zhi-he sat fidgeting at the table, knowing that it was about time for him to leave. All around him sat relatives from an extended family that had gathered for a momentous occasion: the 90th birthday of Liu's great-grandmother Ling Shu Zhen, the still spry and elegant matriarch of a sprawling clan. But Liu had to leave because it was time for him to go to school. This Saturday, as he does every Saturday, Liu was attending two special classes. He takes a math tutorial, and he studies English.

Liu is 7 years old.

A lot of foreigners—and, indeed, a fair number of Chinese—believe that the obsession (and that's the right word) with education in China is overdone. The system stresses rote memorization. It drives kids crazy—aren't 7-year-olds supposed to have fun on Saturday afternoons?—and doesn't necessarily prepare them, economically speaking, for the job market or, emotionally speaking, for adulthood. Add to that the fact that the system, while incredibly competitive, has become corrupt.

All true—and all, for the most part, beside the point. After decades of investment in an educational system that reaches the remotest peasant villages, the literacy rate in China is now over 90%. (The U.S.'s is 86%.) And in urban China, in particular, students don't just learn to read. They learn math. They learn science. As William McCahill, a former deputy chief of mission in the U.S. embassy in Beijing, says, "Fundamentally, they are getting the basics right, particularly in math and science. We need to do the same. Their kids are often ahead of ours."

What the Chinese can teach are verities, home truths that have started to make a comeback in the U.S. but that could still use a push. The Chinese understand that there is no substitute for putting in the hours and doing the work. And more than anything else, the kids in China do lots of work. In the U.S., according to a 2007 survey by the Department of Education, 37% of 10th-graders in 2002 spent more than 10 hours on homework each week. That's not bad; in fact, it's much better than it used to be (in 1980 a mere 7% of kids did that much work at home each week). But Chinese students, according to a 2006 report by the Asia Society, spend twice as many hours doing homework as do their U.S. peers.

Part of the reason is family involvement. Consider Liu, the 7-year-old who had to leave the birthday party to go to Saturday school. Both his parents work, so when he goes home each day, his grandparents are there to greet him and put him through his after-school paces. His mother says simply, "This is normal. All his classmates work like this after school."

Yes, big corporate employers in China will tell you the best students coming out of U.S. universities are just as bright as and, generally speaking, far more creative than their counterparts from China's élite universities. But the big hump in the bell curve—the majority of the school-age population—matters a lot for the economic health of countries. Simply put, the more smart, well-educated people there are—of the sort that hard work creates—the more economies (and companies) benefit. Remember what venture capitalist Tam said about China and the electric-vehicle industry. A single, relatively new company working on developing an electric-car battery—BYD Co.—employs an astounding 10,000 engineers.

China, critics will point out, doesn't produce (at least not yet) many Nobel

Prize winners. But don't think the basic educational competence of the workforce isn't a key factor in its having become the manufacturing workshop of the world. It isn't just about cheap labor; it's about smart labor. "Whether it's line workers or engineers, we're finding the candlepower of our employees here as good as or better than anywhere in the world," says Nick Reilly, a top executive at General Motors in Shanghai. "It all starts with the emphasis families put on the importance of education. That puts pressure on the government to deliver a decent system."

And the Chinese government responds to that pressure in some intriguing ways.

'They are getting the basics right, particularly in math and science. Their kids are often ahead of ours.'

—WILLIAM MCCAHILL, FORMER DEPUTY CHIEF OF MISSION, U.S. EMBASSY, BEIJING

It insists that primary-school teachers in math and science have degrees in those subjects. (Less than half of eighth-grade math teachers in the U.S. majored in math.) There is a "master teacher" program nationwide that provides mentoring for younger teachers. Zhang Dianzhou, a professor emeritus of mathematics at East China Normal University in Shanghai who co-chaired a committee charged with redesigning high school mathematics programs across the country, says recent changes have begun to reflect more of a "real-world emphasis." Computer-science courses, for example, have been integrated into the math curriculum for high school students. And China is placing even more importance on teaching young students English and other foreign languages. If you think China's willingness to constantly fine-tune its educational system is not going to have much of an impact 20 years from now, there's a 7-year-old boy in Shanghai who'd be happy to discuss the issue with you. In English.

LESSON

3 三

Look After the Elderly

IT'S HARD TO IMAGINE TWO SOCIETIES that deal with their elderly as differently as the U.S. and China. And I can vouch for that firsthand. My wife Junling is a Shanghai native, and last month for the first time we visited my father at a nursing home in the U.S. She was shaken by the experience and later told me, "You know, in China, it's a great shame to put a parent into a nursing home." In China the social contract has been straightforward for centuries: parents raise children; then the children care for the parents as they reach their dotage. When, for example, real estate developer Jiang Xiao Li and his wife recently bought a new, larger apartment in Shanghai, they did so in part because they know that in a few years, his parents will move in with them. Jiang's parents will help take care of Jiang's daughter, and as they age, Jiang and his wife will help take care of them. As China slowly develops a better-funded and more reliable social-security system for retirees—which it has begun—the economic necessity of generations living together will diminish a bit. But no one believes that as China gets richer, the cultural norm will shift too significantly.

To a degree, of course, three generations living under one roof has long happened in the U.S., but in the 20th century, America became a particularly mobile and rootless society. It is hard to care for one's parents when they live three time zones away.

Home care for the elderly will most likely make a comeback in the U.S. out of sheer economic necessity, however. The number of elderly Americans will soar from 38.6 million in 2007 to 71.5 million in 2030. But, says Arnold Eppel, who recently retired as head of the department of aging in Baltimore County, Maryland, "There won't be enough spots for them" in the country's overwhelmed nursing-home system. Appreciating the magnitude of the coming crisis, the U.S. government has begun to respond. Two new initiatives—Nursing Home Diversion and Money Follows the Person—expand subsidies for home elder care, and the Veterans Health

Filial piety is a virtue *Most Chinese seniors live with and are cared for by their relatives*

Administration has just put in effect its own similar initiative. "The whole trend will be into home care, because nursing homes are too expensive," Eppel says, noting that nursing-home care in the U.S. costs about $85,000 annually per resident.

In China, senior-care costs are, for the most part, borne by families. For millions of poor Chinese, that's a burden as well as a responsibility, and it unquestionably skews both spending and saving patterns in ways that China needs to change (*see* Save More, *below*). For middle-class and rich Chinese, those costs are a more manageable responsibility but one that nonetheless ripples through their economic decision-making. Still, there are benefits that balance the financial hardship: grandparents tutor young children while Mom and Dad work; they acculturate the youngest generation to the values of family and nation; they provide a sense of cultural continuity that helps bind a society. China needs to make obvious changes to its elder-care system as it becomes a wealthier society, but as millions of U.S. families make the brutal decision about whether to send aging parents into nursing homes, a bigger dose of the Chinese ethos may well be returning to America.

LESSON

4 四

Save More

YOU'VE NOW HEARD IT SO MANY TIMES, you can probably repeat it in your sleep. President Obama will no doubt make the point publicly when he gets to Beijing: the Chinese need to spend more; they need to consume more; they need—believe it or not—to become more like Americans, for the sake of the global economy.

And it's all true. But the other side of that equation is that the U.S. needs to save more. For the moment, American households actually are doing so. After the personal-savings rate dipped to zero in 2005, the shock of the economic crisis last year prompted people to snap shut their wallets. Now that it's pouring, in other words, American households have decided to save for a rainy day. The savings rate is currently about 4% and has gone as high as 6% this year.

In China, the household-savings rate exceeds 20%. It is partly for straightforward policy reasons. As we've seen, wage earners are expected to care for not only their children but also their aging parents. And there is, to date, only the flimsiest of publicly funded health care and pension systems, which increases incentives for individuals to save while they are working. But China, like many other East Asian countries, is a society that has esteemed personal financial prudence for centuries. There is no chance that will change anytime soon, even if the government creates a better social safety net and successfully encourages greater consumer spending.

Why does the U.S. need to learn a little frugality? Because healthy savings rates, including government and business savings, are one of the surest indicators of a country's long-term financial health. High savings lead, over time, to increased investment, which in turn generates productivity gains, innovation and job growth. In short, savings are the seed corn of a good economic harvest.

The U.S. government thus needs to get in on the act as well. By running perennial deficits, it is dis-saving, even as households save more. Peter Orszag, Obama's Budget Director, recently called the U.S. budget deficits unsustainable—this year's is $1.4 trillion—and he's right. To date, the U.S. has seemed unable to have what Indiana Governor Mitch Daniels has called an "adult conversation" about the consequences of spending so much more than is taken in. That needs to change. And though Hu Jintao and the rest of the Chinese leadership aren't inclined to lecture visiting Presidents, he might gently hint that Beijing is getting a little nervous about the value of the dollar—which has fallen 15% since March, in large part because of increasing fears that America's debt load is becoming unmanageable.

That's what happens when you're the world's biggest creditor: you get to drop hints like that, which would be enough by themselves to create international economic havoc if they were ever leaked. (Every time any official in Beijing muses publicly about seeking an alternative to the U.S. dollar for the $2.1 trillion China holds in reserve, currency traders have a heart attack.) If Americans became a bit more like the Chinese—if they saved more and spent less, consistently over time—they wouldn't have to worry about all that.

LESSON

5 五

Look over the Horizon

THE ENERGY THAT SO MANY OUTSIDERS feel when they are in China and that President Obama may see when he is there comes not just from the frenetic activity that is visible everywhere. It comes also from a sense that it's harnessed to something bigger. The government isn't frantically building all this infrastructure just to create make-work jobs. And kids aren't studying themselves sleepless because it's a lot of fun. A few years ago, I interviewed Zhang Xin, a young man from a deeply poor agricultural province in central China. His parents were wheat farmers and lived in a tiny one-room house next to the fields. He had graduated from Tsinghua University—China's MIT—and gotten a job as a software engineer at Huawei, the Cisco of China. His success, Zhang told me one day, had changed his family forever. None of his descendants would "ever work in the wheat fields again. Not my children. Not their children. That life is over." (And neither would his parents. They moved to prosperous Shenzhen, just north of Hong Kong, soon after he started his new job.)

Multiply that young man's story by millions, and you get a sense of what a forward-looking country this once very backward society has become. A smart American who lived in China for years and who wants to avoid being identified publicly (perhaps because he'd be labeled a "panda hugger," the timeworn epithet tossed at anyone who has anything good to say about China) puts it this way: "China is striving to become what it has not yet become. It is upwardly mobile, consciously, avowedly and—as its track record continues to strengthen—proudly so."

Proudly so, because as Zhang understood, hard work today means a much better life decades from now for those who will inherit what he helped create. And if that sounds familiar to Americans—marooned, for the moment, in the deepest recession in 26 years—it should. ■

TIME : NOVEMBER 30, 2009 . pp. 28-29.

Viewpoint | Zachary Karabell

Can an Eagle Hug a Panda?

There's no great wall between the economies of China and the U.S. Why both nations need each other

HAVING SPENT A WEEK IN ASIA AND three intense days in China, President Barack Obama set a constructive tone for the future. He welcomed the emergence of China as a new force in the global economy and rebuffed suggestions that its rise should be seen as a sign of American decline. Chinese officials expressed concern about a weak dollar but committed to working with the U.S. to stabilize the global system. Hardly anything concrete was accomplished, but the trip cemented the centrality of the U.S.-China economic relationship and the fact that the two economies are, for now, intertwined.

Nonetheless, as Obama returns to pressing domestic issues and international flash points such as Iran and Afghanistan, two awkward numbers linger in the background: 3.5 and 8.9. The first is the rate of growth for the U.S. in the third quarter of 2009; the second is how fast China grew. And while GDP statistics are a flawed indicator, the contrast between the two economies remains stark.

China has been on an unconventional and unexpected journey that began after the tragedy of Tiananmen Square 20 years ago. The U.S., after half a century of global economic dominance, finds itself at a crossroads, unable to generate the growth that so many Americans expect and the services so many need, and still struggling to revitalize an economy that for so many years was the envy of the world. The U.S. has been accumulating debt and owes about $800 billion to China alone; China has been building reserves and now has in excess of $2.2 trillion. China remains a poorer country on a per capita basis but is rapidly becoming an economic superpower. The U.S. is one of the most prosperous and stable countries in the world, but its system is showing signs of age.

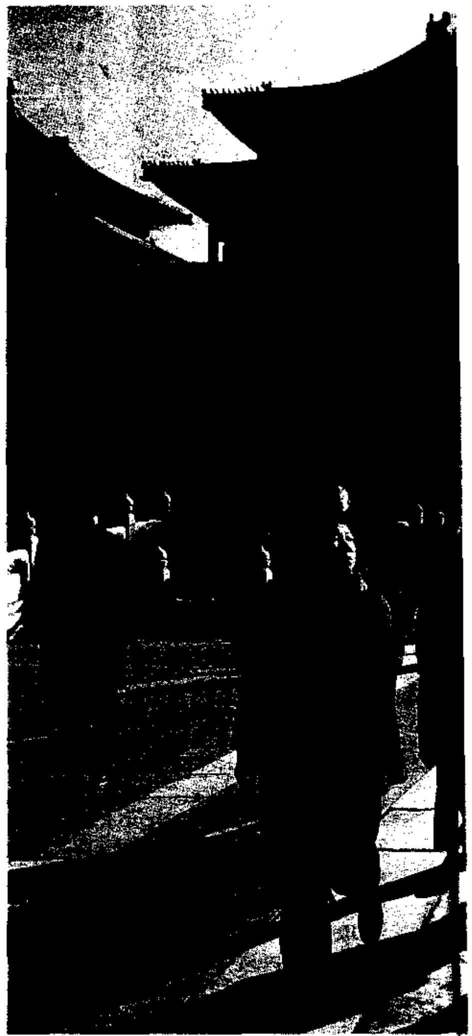
Both Chinese and Americans view their interdependence warily. Yet it may have been why the financial crisis did not result in a worldwide Great Depression

Both Chinese and Americans view their economic interdependence warily. Yet in many respects the relationship has been mutually beneficial and may have been the primary reason the financial crisis did not result in a worldwide Great Depression. China was able to spend aggressively because for 20 years U.S. businesses had been investing in the Chinese economy, building factories, adding liquidity to Chinese banks, opening stores ranging from Avon boutiques to Kentucky Fried Chicken outlets, making cars, selling power turbines and semiconductors—all of which were essential to the rapid urbanization and modernization of China and the emergence of a vibrant middle class.

Scrap Metal and Bridal Gowns

YOU COULD THROW A DART AT A CHART of S&P 500 companies and come up with a China story. Intel is spending hundreds of millions of dollars to build a gleaming new factory in the northern Chinese city of Dalian. Nike signed up Chinese basketball wunderkind Yao Ming and then a gaggle of élite Chinese athletes to become the most popular sports brand in the country, growing 22% this year in China compared with barely 2% in the U.S. FedEx invested billions in logistics in China and the Pacific Rim, not just enabling foreign companies to function more smoothly but also exporting knowledge of modern shipping in the process. The cumulative result was a transfer of capital, yes, but more vitally of knowledge that has been the key to China's success.

But the benefits have flowed in both directions. Take Walmart. By some estimates, over the past several years, the retailer alone has accounted for 15% of U.S. imports from China, which would mean in excess of $30 billion this year. As those goods enter the port of Long Beach, Calif., they require American workers to offload them, American trains and trucks to ship them and American workers to sell them.



In Beijing *President Obama's trip to China stressed the U.S. and China's economic ties*

None of those facts are visible in the trade statistics, yet they are real. And take a company like Schnitzer Steel of Oregon, a once regional company that collects and sells scrap metal. Had it not been for Chinese demand driving up the cost of scrap, Schnitzer would not have seen the soaring profits that allow it to employ more than 3,000 people. Or consider the Greek-American businessman I sat next

XINHUA/ZUMA

to on a long flight to Hong Kong who was able to turn his small wedding boutique into a regional chain with his own line in department stores because of the efficiencies that flowed from making his dresses in China. Those stores employed American workers and helped women of modest means realize their wedding dreams. You could fill a year's worth of magazines with similar examples.

And yet it's fair to say that the relationship between China and the U.S. is not something that most Chinese or Americans like. Say China to many Americans, and they will speak of cheap and potentially dangerous products, unfair trade practices, human-rights violations and outsourcing. Mention the U.S. to many Chinese, and they will speak of arrogance, mismanagement of the economy and hypocrisy. One of the most popular books in China this year is *China Is Not Happy*, and the source of that unhappiness is an overly dependent relationship with the U.S. The two governments share some of those anxieties. Beijing worries that the continuing struggles of the U.S. economy will impair a $338 billion market for its exports and imperil its dollar-denominated investments. China pegged its currency to the dollar years ago in order to hitch its wagon to the world's most dynamic economy but today worries that a declining dollar will impede China's growth. Many in Washington and on Wall Street believe that China's currency policy gives it unfair advantages in trade and that its reliance on state spending rather than domestic consumption is a core cause of the global economic crisis.

Chicken Parts and Tires

BUT THE SAME AMERICANS WHO SPEAK darkly of the China effect routinely seek out the least expensive cell phones, televisions and clothing and demand that companies whose stocks they invest in show double-digit profit growth. Procter & Gamble needs the supercharged gains of its Oil of Olay brand in China to remain compelling to investors. The Otis Elevator Co., a unit of United Technologies, makes great elevators, but it's China that's erecting thousands of skyscrapers. And the same Chinese who snap up copies of *China Is Not Happy* seek business deals with American companies, crave access to U.S. intellectual property and hunger for the brand-name goods produced by American multinationals.

Other than complain, there's little either can do to halt this integration. Punitive tariffs backfire. The Obama Administration's 35% tariff on imports of Chinese tires potentially hurt Goodyear's operations in Ohio because the company had developed a cost structure that uses production in China as a way to maintain its U.S. operations. China threatened to retaliate with tariffs on U.S. chicken parts. If tires and chicken parts are the worst of it, so much for trade wars.

The emergence of China will shape the world much as that of the U.S. did in the late 19th century. What remains to be seen is whether the rise of China will complement the U.S. or undermine it; whether the future will bring a new, cooperative and mutually beneficial economic order rather than a predictable replay of one great power giving way to the next. That future—burgeoning with possibilities and fraught with challenges—is ours to write. ■

Karabell is the author of Superfusion: How China and America Became One Economy and Why the World's Prosperity Depends on It

Time: November 30, 2007. pp. 37-39.

INSIDE
'It's all about shared risks, shared rewards, shared ownership.'
AD-AGENCY EXECUTIVE GRAEME DIGNAN ON CLIENT COLLABORATION

Global Business

□ FINANCE □ MANUFACTURING □ TECHNOLOGY □ TRADE □ MANAGEMENT □ MARKETS

Window shopping A Xi'an consumer is reflected in the glass of an electronics store

ECONOMY

Rebalancing Act. Rapid growth in China's west is bringing new riches to its residents—and hope for the global economy

BY MICHAEL SCHUMAN/XI'AN

THOUGH HE DOESN'T KNOW IT, SHOP MANager Zhu Baohua is on the front lines of the battle to reform the global economy. Zhu's three-floor electronics store, crammed with Sony TVs, Motorola cell phones and HP PCs, is located in a nondescript neighborhood in the western Chinese city of Xi'an. Far from China's dynamic coastal manufacturing and financial centers, Xi'an for decades has been an economic backwater known mainly as the home of China's famed terra-cotta warriors, reminders of the city's glory days as a capital of ancient dynasties.

But today, Xi'an is experiencing a renaissance. The locals who frequent Zhu's store have cash—and they're spending it like never before. On a recent Wednesday in late October, hospital worker Hao Jie, 40, is gleeful after dropping $1,200 on a 52-inch LCD TV for her new apartment, the keys to which she received only days earlier. Nearby, a soon-to-be-married young couple, Zhang Guopeng and Luo Xi, sizes up washing machines using a measuring tape. The two engineers are also shopping to fill up a new apartment, their first home together. For Zhu, the busy Wednesday evening is business as usual. His store's sales have surged about 40% this year. "In the past, people only bought the electronics that

Photographs for TIME by Tomas van Houtryve—Panos they needed," Zhu says. "Now people are spending money just to enjoy it."

This kind of exuberant consumer behavior helps to explain why China has powered through the global recession with only limited damage. Local officials expect Xi'an's gross domestic product to surge 13.5% in 2009, far faster than the central government's 8% target for the national economy. Even more importantly, the thriving economy in this city of 8 million lends hope that China might be able to complete its next great economic transformation. China has come to depend too much upon exports and investment for growth. What's needed is economic rebalancing, so that domestic consumption contributes more to expansion. This transition would help not only China—it would also help to stabilize the global economy by easing China's massive trade and current-account surpluses. With American consumer spending on the wane, China needs to rely less on U.S. markets to absorb its manufactured goods. The country's growing armies of middle-class consumers are being called upon to fill the vacuum to ensure the country can remain on its blistering growth trajectory.

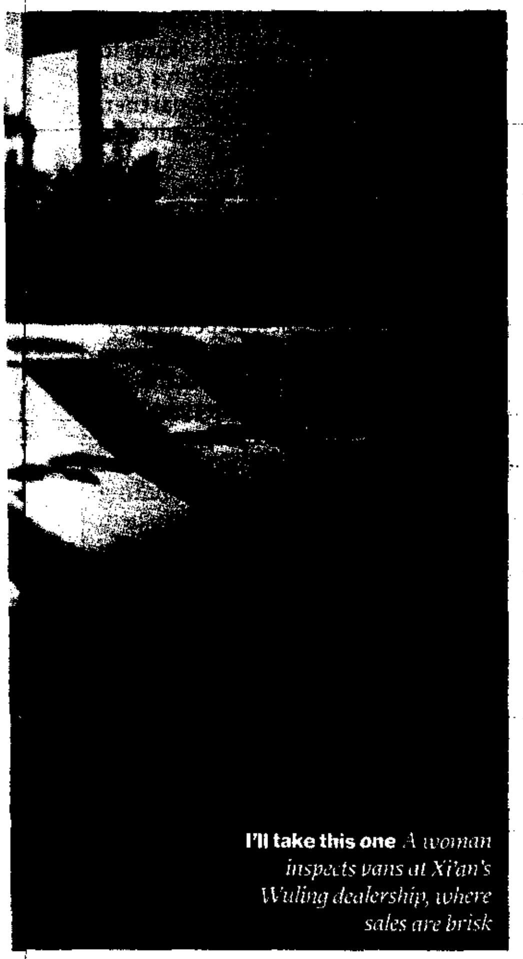
Surprisingly, it is provincial cities like Xi'an that are leading this transition. In China's heartland, you won't find many factories churning out cheap toys or clothing for overseas markets, the kind of industrial activity that underpinned China's economic miracle and made Shanghai and Shenzhen wealthy. Total international trade represents a mere 18% of Xi'an's GDP, compared with 160% in Shanghai. Xi'an is being built instead on the burgeoning spending power of its own consumers, and on the expansion of Chinese companies churning out products for Chinese. "The domestic market will be the leading reason for China's future development," says Chen Baogen, Xi'an's mayor. "Xi'an is different from the coastal cities."

For much of China's recent history, this difference was a liability. The country's vast, mostly agrarian West was isolated from the international economy and lagged badly behind the booming east coast in progress and prosperity. Nine years ago, Beijing sought to begin closing this development gap by investing heavily in highways, airports and other infrastructure across the western region. This has helped to kick-start growth. So has geography: Xi'an's lack of exposure to crashing global markets means it has barely been singed by the crisis. In fact, the city has benefited. It's received $230 million of Beijing's $585 billion stimulus package, which helped accelerate the construction of a new subway system, highways and other projects. A similar scenario has been playing out in other western China cities like Chengdu and Chongqing. BofA Merrill Lynch Global Research calculates that the GDP of China's western provinces grew 9.3% in the first half of 2009, compared with 6.5% in the east. This trend is likely to continue. "Growth is shifting to the interior," says Ting Lu, a BofA Merrill Lynch economist.

That's not only because of government largesse. As wages and land prices rise precipitously in China's coastal cities, Chinese companies based there are investing in operations in less-developed Xi'an to capitalize on its lower costs and tap a cheaper labor market. About 70% of Xi'an's domestic investment comes from the southeast coast. For example, in late 2008 Shenzhen-based cell-phone maker ZTE announced it would invest $880 million in manufacturing and research facilities in Xi'an that will ultimately employ 26,000 people. Hybrid-car maker BYD, also headquartered in Shenzhen, has turned Xi'an into one of its main manufacturing centers, with almost all of the cars sold to Chinese consumers. Earlier this year, the company launched a $585 million plant expansion to produce another 300,000 cars in Xi'an. In all, domestic investment in the city surged 31% to $8.1 billion in the first three quarters of 2009 from a year earlier.

'The domestic market will be the leading reason for China's future development.'
—CHEN BAOGEN, MAYOR OF XI'AN

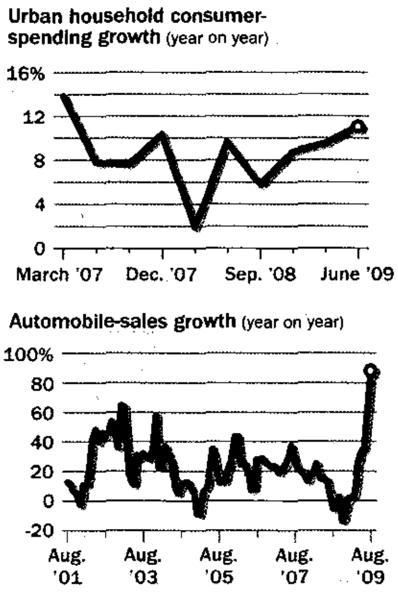
Foreign investment is migrating to Xi'an for similar reasons. Unlike on the coast, where Hong Kong and Taiwan companies have set up countless export factories, the investments in Xi'an tend to be more domestically focused. In October, Applied Materials, a California-based maker of manufacturing equipment for the semiconductor industry, opened a solar-power research center in Xi'an, part of a $250 million investment in the city. The facility, unique to Applied Materials' global operations, will house solar-cell production lines to devise new ways of bringing down the costs of manufacturing panels. Though the results can be utilized in factories anywhere, the center is directed to a



I'll take this one *A woman inspects vans at Xi'an's Wuling dealership, where sales are brisk*

Spending Again

As the economy rebounds, Chinese are loosening their purse strings



Sources: NBS; CEIC; GS Global ECS Research

great degree at expanding the company's business within China. "China is where all the customers are," says Charles Gay, president of the company's solar-power division. "The business is growing faster here than anywhere else on the planet."

New investment and development has translated into prosperity for Xi'an residents. The per capita GDP of the city has increased 150% between 2001 and 2008 to $3,800 (though it remains far behind rich coastal cities like Shanghai, where GDP per capita exceeds $10,500). Consumer spending is growing quickly as well. In the first nine months of 2009, retail sales in Xi'an jumped 19% compared to those in the same period a year earlier, well above the 14.8% posted in China's cities nationally. BofA Merrill Lynch estimates that retail sales in the western provinces rose 19.2% in the first half of 2009, 3 percentage points more than in the east. "Xi'an has reached a very important development stage," explains Chen, Xi'an's mayor. "Incomes are just at the first point when people can buy homes and cars."

That fact was obvious one recent Wednesday morning at a Wuling minivan dealership in Xi'an. Customers streamed into the showroom, briefly opened and closed the doors of the displayed minivans, and then marched over to the front desk to plop down their money, often within mere minutes of arriving. Xu Zhanrong, the dealership's deputy general manager, can barely keep the Wulings in stock. Sales of the minivans—manufactured by a joint venture between General Motors, Liuzhou Wuling Motors and Shanghai Automotive Industry—are up some 40% this year, Xu says, with about 50 purchased each day. One big reason, Xu explains, is that his customers, and especially those who come in from the nearby countryside, don't worry as much about saving for their old age as they had in the past. "Now they find they have more money, to spend and enjoy life more, however they want to use it," Xu says. "From what I see, people are changing very dramatically."

To keep that change going, the Chinese government has more work to do, however. Though the ingredients of rebalancing might be percolating in Xi'an and the rest of China, making it actually happen will take additional reform. The economy is still too dependent on investment and government spending instead of private consumption. Even though consumer spending is increasing, it is not growing quickly enough. Private consumption's role in the economy has actually been declining, to a mere 35% of GDP in 2008 from 46% in 2000. Economists say policymakers need to speed up the development of a better social safety network, encourage small-scale finance and liberalize service industries dominated by big state firms to further raise incomes and encourage Chinese to spend more and save less.

There is also concern that growth will slip backward once China's recession-fighting stimulus is scaled back. One reason Xu's minivan sales have accelerated is government tax breaks and rebates offered on certain car purchases—incentives that won't last forever. State subsidies have also been given to rural residents to spur sales of refrigerators and washing machines. Though the government is implementing longer-lasting plans to convince citizens to spend more money (including a $125 billion program to improve national health care, especially in less developed regions), those efforts will take years to reach their full impact.

Yet there are signs that there may be enough solid demand within China's domestic market to keep Xi'an's growth story alive. Carsten Wiegandt, the German acting general manager of the Kempinski Hotel, located on the city's outskirts, has been surprised by the kind of visitors filling his rooms. After the five-star hotel opened in June 2008, management expected tourists arriving from overseas to see the terracotta warriors. When the global recession hit, he feared his business might suffer. Instead he found visitors pouring in from other parts of China, many attending conferences being held by Chinese companies at the hotel. Now, with Chinese clientele making up 80% of his business, Wiegandt has refocused his marketing efforts away from the U.S. and Europe and toward big Chinese cities like Shanghai and Beijing. "I didn't expect the domestic market to be so strong," he says.

But perhaps the biggest reason for optimism is Xi'an residents like Lu Bo. The 32-year-old says the salary he earns as a salesman in the air-freight department at China Eastern Airlines was reduced by a third last year when his company was hit hard by the financial crisis, but that hasn't stopped him from spending. So confident is he about the future, he recently went out shopping for a new refrigerator. "Judging from my job, my life, I think everything will become better and better," Lu says. And maybe for the entire world economy as well. —WITH REPORTING BY CHENGCHENG JIANG/XI'AN ■